EMPLOYEE BENEFIT PLANS
EXPLANATION NO. 5A
COVERAGE AND NONDISCRIMINATION REQUIREMENTS: DEFINED BENEFIT PLANS

The purpose of Form 9638, Worksheet Number 5A, is to identify major problems in defined benefit plans relating to the minimum coverage and nondiscrimination requirements of the Code and associated requirements. These include the requirements of sections 401(a)(4) and 410(b) of the Code, the minimum participation requirements of section 401(a)(26), and the nondiscriminatory compensation requirements of section 414(s). (Certain related requirements, such as the limitation on compensation under section 401(a)(17) of the Code, are addressed in other worksheets.) This worksheet also addresses certain requirements of the qualified separate lines of business rules of section 414(r) of the Code.

If the plan is intended to satisfy the nondiscrimination in amount requirement under section 401(a)(4) as a design-based safe harbor plan and the plan provides for permitted disparity, Worksheet Number 5B may be used to determine whether the disparity satisfies the requirements of section 401(l) of the Code. Explanation Number 5C should also be used in reviewing a plan where the employer has requested a determination that the plan satisfies the nondiscrimination in amount requirement by satisfying a general test or where the plan is intended to satisfy the minimum coverage requirements by satisfying the average benefit test.

Although this worksheet relates to defined benefit plans, certain requirements that pertain primarily, or solely, to defined contribution plans are also discussed in the explanations.

Generally, a Yes answer to a question on the worksheet indicates a favorable conclusion while a No answer signals a problem concerning plan qualification. This rule may be altered by specific instructions for a given question. Please explain any No answer in the space provided on the worksheet.

References at the end of each paragraph in the explanation are to the Internal Revenue Code and the Income Tax Regulations unless otherwise noted.

The technical principles in this publication may be changed by future regulations or guidelines.

Department of the Treasury
Internal Revenue Service
Document 9242 (Rev. 4-2000)

I. General Requirements

Determination letter applicants are generally required to include with their applications Schedule Q (Form 5300) which serves to identify particular issues to be considered in determining the qualified status of the plan and additional information (in the form of demonstrations) that the applicant is required to submit in support of its application.

Schedule Q is generally required to be submitted with all applications, including applications filed on Form 5307 (for M&P, regional prototype, and volume submitter plans) or Form 5310 (for terminating plans). The only exceptions are for state and local government plans and certain plan amendments filed on Form 6406 that do not involve a significant change to plan benefits or coverage.

The specific instructions to Schedule Q ask the applicant to enter in the application the letter below that corresponds to the best description of the plan. The applicant's response determines which other questions need to be answered and which demonstrations need to be submitted with the application. The applicant's response therefore identifies, in part, the issues that need to be considered in determining the plan's qualified status and, consequently, the parts of this worksheet that need to be completed. The specialist should use the following guide, based on the potential responses to Schedule Q, to identify the parts of this worksheet that should be completed.

A = This indicates that the plan benefits only collectively bargained employees. The worksheet does not have to be completed.

B = This indicates that the plan is a governmental plan as defined in section 414(d). The worksheet does not have to be completed.

C = This indicates that the plan is maintained by an employer exempt from income tax under section 501(a). Complete all applicable parts of the worksheet.

D = This indicates that the plan does not benefit any highly compensated noncollectively bargained employees and is treated as automatically satisfying the coverage and nondiscrimination requirements of sections 401(a)(4) and 410(b). Complete only Parts I, II, and III of the worksheet.

E = This indicates that the plan is maintained by an employer that does not employ any nonhighly compensated noncollectively

bargained employees and is treated as automatically satisfying the coverage and nondiscrimination requirements of sections 401(a)(4) and 410(b). Complete only Parts I, II, and III of the worksheet.

F = This indicates that the plan is a nonstandardized safe harbor M&P or regional prototype plan approved under Rev. Proc. 93-10, 1993-1 C.B. 476, that (**1**) satisfies the coverage requirements without relying on the average benefit test; (**2**) is neither permissively aggregated with another plan to pass coverage, nor maintained by an employer that is treated as operating qualified separate lines of business; and (**3**) does not use a definition of compensation that must be tested for nondiscrimination under Regulations section 1.414(s)-1(d). Complete Parts I, II, III, and V only.

G = This indicates that the plan is a nonstandardized safe harbor M&P or regional prototype plan approved under Rev. Proc. 93-10 that would be described in the preceding paragraph except that it uses a definition of compensation that must be tested for nondiscrimination under Regulations section 1.414(s)-1(d). Complete Parts I, II, III, V, and XIII only.

H = This indicates that the plan is not described above and **I** does not apply. Complete all applicable parts of the worksheet.

I = This indicates that the plan is a standardized M&P or regional prototype plan. The worksheet does not have to be completed.

Note that in some other circumstances certain parts of the worksheet need not be completed. For example, those parts of the worksheet pertaining to restrictions on distributions under section 1.401(a)(4)-5(b) of the regulations and Rev. Rul. 92-76 need not be completed for any M&P or regional prototype plan.

II. Qualified Separate Lines of Business (QSLOB)

Section 414(r) of the Code and the regulations thereunder prescribe conditions under which an employer is treated as operating qualified separate lines of business (QSLOBs). If an employer (determined in accordance with the provisions of section 414(b), (c), (m), and (o)) is treated as operating QSLOBs, the minimum coverage requirements of section 410(b), including the nondiscrimination requirements of section 401(a)(4), and the minimum participation requirements of section 401(a)(26) may be applied separately with respect to the employees of each QSLOB.

That is, the employees of each QSLOB are treated as if they were the only employees of the employer.

Additionally, if a plan benefits the employees of more than one QSLOB, the plan is disaggregated into two or more separate disaggregated plans (one for each QSLOB that has employees in the plan), and in testing each separate disaggregated plan for compliance with the coverage and nondiscrimination requirements or the minimum participation requirements, the employees of the other QSLOBs are treated as excludable employees and are thus disregarded.

In general, if the employer is applying the minimum coverage and nondiscrimination requirements separately with respect to the employees of a QSLOB, it must do so with respect to all its plans, employees, and QSLOBs. The same all-or-nothing rule applies in the case of the minimum participation requirements of section 401(a)(26). (In both cases, there is an exception, discussed in line c.) However, the fact that the employer is using the QSLOB rules for purposes of sections 410(b) and 401(a)(4) does not require the use of these rules for purposes of section 401(a)(26), or vice versa. In fact, for purposes of satisfying the requirements of section 401(a)(26) on a QSLOB basis, the general requirement under section 414(r) that a line of business have at least 50 employees does not apply.

This is a year by year issue. That is, for any given testing year (i.e., calendar year), the employer may decide whether or not to treat itself as operating QSLOBs. Whatever the choice, it will generally apply to all plans of the employer for plan years that begin in the testing year.

414(r)
1.414(r)-0 through 11

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line a. When an employer files a determination letter request for a plan, it must indicate whether it is treating itself as operating QSLOBs for purposes of testing any plan's compliance with the coverage and nondiscrimination or minimum participation requirements. The employer must also include with its application a demonstration (which should be labeled Demo 1) that identifies each QSLOB that has employees benefiting under the plan and the section(s) of the Code for which it is testing on a QSLOB basis (i.e., 410(b) and 401(a)(4) or 401(a)(26)).

The determination of whether an employer is treated as operating QSLOBs is generally to be made by the employer. That is, employers may not rely on favorable determination letters issued for plans as evidence that they are entitled to be treated as operating QSLOBs and specialists should not seek to determine that the requirements of section 414(r) have been satisfied,

except as described below.

In some situations, employers may request a determination from the National Office that a QSLOB satisfies a requirement of the regulations that is called the "administrative scrutiny" requirement. An employer that has a request for an administrative scrutiny determination pending with the National Office when it files a determination letter application is to attach a copy of National Office's confirmation receipt to its application. In this case, the specialist should contact the National Office regarding the status of the administrative scrutiny determination before issuing a determination letter for the plan.

414(r)
1.414(r)-1, 8, and 9
Rev. Proc. 98-6 and Schedule Q

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line b. If the employer has indicated that it is treating itself as operating QSLOBs for purposes of the minimum coverage requirements of section 410(b), then it is required to apply the minimum coverage requirements and nondiscrimination requirements separately to the employees of each QSLOB in testing whether all plans of the employer meet the coverage requirements. (An exception is discussed in line c.) In this case, the plan will satisfy the minimum coverage requirements only if (a) the plan benefits a classification of employees that is nondiscriminatory on an employer-wide basis and (b) the plan satisfies the minimum coverage requirements on a QSLOB basis. Thus, in addition to having to satisfy coverage on a QSLOB basis, the plan must first pass a nondiscriminatory classification "gateway" on an employer-wide basis.

The coverage requirements are discussed in general in Part V of the worksheet. Complete Part V to determine if the plan satisfies coverage on a QSLOB basis.

An employer that is using the QSLOB rules for purposes of coverage and nondiscrimination must include in Demo 1 a demonstration that the plan meets the gateway nondiscriminatory classification requirement. This requirements is satisfied if the demonstration shows that either (a) the plan satisfies the ratio percentage test, or (b) the plan satisfies the nondiscriminatory classification test. (See Part V for definitions of these terms.)

Under the coverage rules, a plan that benefits the employees of more than one QSLOB is disaggregated and treated as consisting of separate plans for each QSLOB. In this case, the coverage

requirements, including the gateway test, must be satisfied separately by each disaggregated plan.

The gateway test is performed on an employer-wide basis. Therefore, in making the demonstration the employer may not treat employees as excludable merely because they are in separate QSLOBs. That is, all employees of the employer who are not otherwise excludable are counted as nonexcludable employees for purposes of the gateway test, regardless of QSLOB. However, because plans that benefit employees of more than one QSLOB are disaggregated, in testing a plan with respect to the employees of one QSLOB, the employees of other QSLOBs are not treated as benefiting even though they may not be treated as excludable.

Certain nondiscrimination rules under section 401(a)(4) require that a group of employees under the plan satisfy section 410(b) in order to satisfy section 401(a)(4). For example, the general tests for nondiscrimination in amount require each rate group under the plan to satisfy section 410(b). Also, a benefit, right, or feature will satisfy the current availability requirement only if it is currently available to a group of employees that satisfies section 410(b). (See Part V.) Likewise, in order to satisfy section 401(a)(4), a plan may be restructured into component plans provided each component plan would satisfy sections 401(a)(4) and 410(b) as if it were a separate plan. (See Part IV.) If the employer is using the QSLOB rules for coverage and nondiscrimination, then in applying these nondiscrimination requirements, section 410(b) is to be applied in the same manner as it is applied for purposes of the coverage requirements. That is, the applicable group of employees must satisfy the gateway test on an employer-wide basis and must also satisfy section 410(b) on a QSLOB basis, in both cases as if the applicable group of employees were the only employees benefiting under the plan.

For example, if the employer is demonstrating that a benefit, right, or feature satisfies current availability and the employer is using the QSLOB rules for purposes of coverage and nondiscrimination, the employer must generally show that the group of employees to whom the benefit, right, or feature is currently available satisfies the gateway test on an employer-wide basis and section 410(b) on a QSLOB basis, in both cases as if the group of employees to whom the benefit, right, or feature is currently available were the only employees benefiting under the plan.

If the employer is demonstrating the gateway test by showing that the plan meets the nondiscriminatory classification test and the ratio percentage falls between the safe and unsafe harbor percentages, the gateway test is satisfied. It is not necessary

in this case to look at the facts and circumstances (as would otherwise be required by the nondiscriminatory classification test) because satisfaction of the requirements of section 414(r) is treated as satisfaction of the facts and circumstances requirement.

In certain circumstances, the employer may reduce the unsafe harbor percentage in the nondiscriminatory classification requirement by five percentage points. In these circumstances, the 20 percent floor on unsafe harbors is also eliminated. These modifications are allowed if the demonstration shows that the ratio percentage for the plan on a QSLOB basis is at least 90 percent. Where the nondiscrimination rules require a group of employees to satisfy section 410(b), as described above, the ratio percentage determined in applying the nondiscrimination rule (on a QSLOB basis) must also be at least 90 percent in order for these modifications to be allowed in applying the gateway test. For example, if the employer is demonstrating that the plan satisfies a general test, these modifications in applying the gateway test may not be made unless the ratio percentage for each rate group under the plan is at least 90 percent.

If a plan would satisfy the preceding paragraph, except that the ratio percentage on an employer-wide basis would still be below the reduced unsafe harbor percentage, it will nevertheless be deemed to satisfy the gateway test if the Commissioner determines, on the basis of all the relevant facts and circumstances, that the plan's classification is not discriminatory.

1.414(r)-8

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line c. An employer that treats itself as operating QSLOBs for purposes of the coverage and nondiscrimination requirements may apply these requirements to a plan on an employer-wide rather than QSLOB basis if the plan benefits at least 70 percent of the employer's nonexcludable nonhighly compensated employees. Where the nondiscrimination rules require a group of employees under the plan to satisfy section 410(b), as described above, the group of employees must also satisfy the 70 percent test on an employer-wide basis. For this purpose, the plan is not disaggregated on the basis of different QSLOBs. If the employer is applying this employer-wide rule to a plan for purposes of coverage and nondiscrimination, it may also use it for purposes of minimum participation for the same plan. Employers using this rule are required to include with Demo 1 a demonstration that they satisfy its requirement.

1.414(r)-1(c)(2)(ii)
1.414(r)-1(c)(3)(ii)

III. ADDITIONAL PARTICIPATION REQUIREMENTS

Section 401(a)(26) requires a qualified defined benefit plan to meet certain minimum participation requirements. A defined benefit plan must satisfy section 401(a)(26) with respect to active employees. A defined benefit plan that provides additional accruals during the plan year to former employees must also satisfy section 401(a)(26) with respect to former employees. Finally, defined benefit plans must satisfy section 401(a)(26) with respect to the plan's prior benefit structure. Determination letter applicants are generally required to demonstrate that their plans satisfy section 401(a)(26) (with the exception of the requirements regarding former employees and a defined benefit plan's prior benefit structure). This demonstration should be identified as Demo 2.

1.401(a)(26)-1(a)
1.401(a)(26)-8

The minimum participation requirements are generally required to be met on each day of the plan year. However, a plan is treated as satisfying the minimum participation requirements for a plan year if it satisfies such requirements on one day of the year, provided that day is reasonably representative of the employer's workforce and the plan's coverage. A plan that fails the minimum participation requirements for the plan year may be retroactively amended by the 15th day of the 10th month following such year to satisfy section 401(a)(26) by, for example, expanding coverage. Plans that are merged by the end of this period will not fail section 401(a)(26) merely because they failed to satisfy section 401(a)(26) prior to the merger.

1.401(a)(26)-7

A plan is deemed to satisfy section 401(a)(26) for a plan year if it is neither top-heavy nor frozen and it meets both the following requirements:

1. The plan benefits no highly compensated employee (HCE) or highly compensated former employee.

2. The plan is not aggregated with any other plan to satisfy section 401(a)(4) or section 410(b) (other than the average benefits percentage test).

1.401(a)(26)-1(b)(1)

An underfunded defined benefit plan is also deemed to satisfy section 401(a)(26) if the following requirements are met:

1. A timely filed actuarial report, as required by section 6059, shows that the plan does not have sufficient assets to satisfy all liabilities under the plan.

2. For the plan year, no employees or former employees accrue additional benefits under the plan except for top-heavy minimum benefits for non-key employees required by section 416.

3. For years beginning on or after January 1, 1992, the plan is subject to Title IV of ERISA or is not top-heavy.

1.401(a)(26)-1(b)(3)

For purposes of section 401(a)(26), each single plan within the meaning of section 414(l) is a separate plan. A plan that benefits the employees of more than one QSLOB is disaggregated and each separate disaggregated plan must separately satisfy section 401(a)(26).

An employer may also elect to treat the portion of a plan that benefits employees who are included in a unit of employees covered by a collective bargaining agreement and the portion of a plan that benefits employees who are not included in such a collective bargaining unit as separate plans for purposes of section 401(a)(26). (This rule may be applied separately to each collective bargaining agreement.) The employer should demonstrate that each such separate plan independently satisfies the requirements of section 401(a)(26). Note that if more than 2 percent of the employees who are covered pursuant to a collective bargaining agreement are professional employees, all employees covered under such collective bargaining agreement are treated as noncollective bargaining unit employees.

1.401(a)(26)-2(c) and (d)
1.401(a)26)-6(b)(4) and (5)

The portion of a multiemployer plan that benefits employees included in a unit of employees covered by a collective bargaining agreement may be treated as a separate plan and is deemed to satisfy the section 401(a)(26) participation requirements. This exception does not apply with respect to a collective bargaining agreement if more than 2 percent of the employees who are covered pursuant to such agreement are professional employees. Such participants are tested as noncollective bargaining unit employees. Any noncollective

bargaining unit employees benefiting under a multiemployer plan must be tested as if they benefit under a noncollectively bargained plan. The applicant must demonstrate that the part of the plan benefiting noncollective bargaining unit employees separately satisfies the requirements of section 401(a)(26) solely by reference to each employer's employees. However, a special testing rule provides that a multiemployer plan that includes noncollective bargaining unit employees will satisfy section 401(a)(26) if the total number of collective bargaining unit and noncollective bargaining unit employees benefiting under the plan is 50 or more. In this case, separate testing of the noncollective bargaining unit employees is not necessary.

1.401(a)(26)-1(b)(2)
1.401(a)(26)-2(d)(1)(ii)

A multiple employer plan is treated as comprising separate plans each of which is maintained by the separate employers. The applicant must demonstrate that each separate plan separately satisfies section 401(a)(26) by reference only to each employer's employees.

1.401(a)(26)-2(d)(1)(ii)

Line a. If the plan does not automatically satisfy section 401(a)(26), it must benefit at least the lesser of: **1**) 50 employees of the employer, OR **2**) the greater of: a) 40 percent of all employees of the employer, or b) 2 employees (or if there is only 1 employee, such employee). A frozen defined benefit plan (i.e., one that provides no additional benefit accruals, other than minimum benefit accruals for nonkey employees required by section 416) also automatically satisfies this requirement (as well as the application of section 401(a)(26) to former employees) and need only satisfy section 401(a)(26) with respect to its prior benefit structure. The definition of employer includes all related employers under section 414(b), (c) or (m). Note that most section 401(a)(26) definitions are found in the section 410(b) regulations.

1.401(a)(26)-2(a) and (b) and 1.401(a)(26)-8

In performing the participation tests, the employees who are excludable are generally the same as those who are excludable for the purposes of performing the coverage tests. See Part V of the worksheet. However, employees covered under a collective bargaining agreement may, at the option of the employer, be treated as excludable employees for the purposes of testing the portion of the plan that benefits noncollective bargaining unit

employees. (This rule may be applied separately to each collective bargaining agreement.) Similarly, noncollective bargaining unit employees may, at the election of the employer, be treated as excludable employees for the purposes of testing the portion of the plan that benefits only collective bargaining unit employees. If more than 2 percent of the employees covered under a collective bargaining agreement are professional employees, all employees covered under the collective bargaining agreement are treated as noncollective bargaining unit employees. In addition, for most plans the definition of who is benefiting under the plan for the purposes of the participation test is the same as the definition of benefiting employees for the purposes of the coverage tests. See Part V.

1.401(a)(26)-5 and 6

Line b. A defined benefit plan must satisfy section 401(a)(26) with respect to former employees for a plan year only if the plan does not meet one of the exceptions to section 401(a)(26) and the plan is providing additional benefit accruals to former employees during the year. This would occur, for example, where the plan is amended to provide an ad hoc cost-of-living increase to former employees.

1.401(a)(26)-4(a)

A plan automatically satisfies section 401(a)(26) with respect to former employees if the plan benefits at least 5 former employees and either:

1. More than 95% of all former employees with vested accrued benefits benefit for the plan year, or

2. At least 60% of the former employees who benefit are nonhighly compensated former employees.

1.401(a)(26)-4(c)

If the plan does not automatically satisfy section 401(a)(26) with respect to former employees, it must benefit at least the lesser of :

1. 50 former employees of the employer, or

2. the greater of:

a. 40% of all former employees of the employer, or

b. 2 former employees (or if there is only 1 former

employee, such former employee).

For this purpose, those former employees excludable in testing for coverage of former employees are excludable. In addition. a former employee may be excluded (other than for the 95%/60% test above) if the present value of the former employee's vested accrued benefit does not exceed $5,000.

Defined benefit plan applicants are not required to submit demonstrations of compliance with section 401(a)(26) with respect to former employees. Line II.b. of the worksheet should be checked Yes unless factors present with the application indicate that the plan may not satisfy section 401(a)(26) with respect to former employees.

1.401(a)(26)-4(c) and 1.401(a)(26)-6(c)

Line c. A defined benefit plan that does not meet one of the exceptions to section 401(a)(26) must also satisfy section 401(a)(26) with respect to its prior benefit structure. A plan's prior benefit structure includes all accrued benefits (including amounts rolled over or transferred to the plan) as of the beginning of the plan year. This test is partly mechanical and partly facts and circumstances. A plan will pass this test if at least the lesser of 50 employees and former employees of the employer or the greater of 40% of all the employer's employees and former employees or 2 employees (or if there is only 1 employee, such employee) have meaningful accrued benefits under the plan. A plan will also pass this test if at least the lesser of 50 employees or the greater of 40% of all the employer's employees or 2 employees (or if there is only 1 employee, such employee) currently accrue meaningful benefits under the plan. (A multiemployer plan will satisfy this rule as long as it provides meaningful benefits (or accrued benefits) to at least 50 employees, considering all employees benefiting under the plan.)

This rule is intended as an anti-abuse rule to prevent employers from maintaining plans the primary purpose of which is to function as individual plans for a few employees or for the employer. Therefore, the question of whether a defined benefit plan has meaningful accrued benefits or is providing meaningful benefit accruals is one of facts and circumstances. For example, an accrued benefit equal to .5% of total compensation times years of participation (or a current accrual rate of .5% of total compensation per year of participation) would generally be considered meaningful. On the other hand, an accrued benefit or current accrual less than this would not necessarily fail to be meaningful.

Factors to consider are: the level of current accruals;

comparative rates of accruals under the current and prior formulas; currently projected accrued benefits versus benefits accrued as of the beginning of the year; how long the current formula has been in effect; how long the plan has been in effect; and the number of employees with accrued benefits under the plan.

Defined benefit plan applicants are not required to submit demonstrations of compliance with the section 401(a)(26) prior benefit structure rules. Line II.c. of the worksheet should be checked Yes unless factors present with the application indicate that the plan is not functioning as an ongoing defined benefit plan providing meaningful benefits to a section 401(a)(26) group of employees.

1.401(a)(26)-3

IV. DISAGGREGATION, PERMISSIVE AGGREGATION, AND RESTRUCTURING

Generally, each single plan must separately satisfy the coverage and nondiscrimination requirements. However, certain types of plans are required to be disaggregated and the separate disaggregated plans that result must separately satisfy coverage and nondiscrimination. In some circumstances, employers may aggregate or combine two or more plans in applying the ratio percentage test or the nondiscriminatory classification test for coverage purposes. (See Part V for a discussion of these terms.) In this case, the aggregate plan is also treated as a single plan for purposes of the nondiscrimination requirements. For example, one plan, when viewed alone, may not satisfy the coverage requirements, but when the plan is combined with another plan, the resulting aggregate plan satisfies both the coverage and nondiscrimination requirements.

Plans may be aggregated only if they have the same plan year. Also, separate plans that would be disaggregated if they were a single plan may not be aggregated, disaggregated parts of plans may not be aggregated, and ESOPs generally may not be aggregated with other ESOPs. Finally, a plan may not be combined with two or more plans to form more than one single plan.

When a defined benefit plan is aggregated with a defined contribution plan, the aggregate DB/DC plan must satisfy the nondiscriminatory amount requirement (discussed in Part X) on the basis of a general test (rather than safe harbors) and special rules apply. See Part X.

Solely for purposes of the nondiscrimination requirements (including the permitted disparity requirements of section 401(l), a plan may be treated as consisting of two or more component plans. This is referred to as restructuring. If each

component plan satisfies the coverage and nondiscrimination requirements as if it were a separate plan, the whole plan will be treated as satisfying the nondiscrimination requirements. The plan must still satisfy the coverage requirements on a nonrestructured basis.

Section 401(k) and 401(m) plans may not be restructured.

410(b)(6)(B)
1.410(b)-7
1.401(a)(4)-1(c)(4)
1.401(a)(4)-9

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line a. When an employer files a determination letter request for a plan, it must indicate whether the plan is mandatorily disaggregated (other than solely as a result of the plan benefiting both collectively bargained and noncollectively bargained employees), permissively aggregated with another plan, or restructured into component plans. If so, the employer is required to include with its application a schedule relating to the disaggregation, aggregation, or restructuring. This should be labeled Demo 4. The information required in this schedule is discussed in lines b. and c.

This line should be checked "yes" if the employer has indicated that the plan is disaggregated, aggregated, or restructured. This line should also be checked "yes" if there is other evidence with the application that the plan is being aggregated with another plan for coverage and nondiscrimination purposes or restructured for nondiscrimination purposes. Lastly, regardless of the employer's response, this line should be checked yes if the plan is required to be disaggregated (other than solely because the plan benefits both collectively bargained and noncollectively bargained employees).

Plans are required to be disaggregated in the following situations:

1. A section 401(k) plan must be disaggregated from the portion of a plan that is not a section 401(k) plan, and a section 401(m) plan must be disaggregated from the portion of a plan that is not a section 401(m) plan. See Alert Guidelines 11 and 12.

2. The ESOP portion of a plan is disaggregated from the nonESOP portion of the plan.

3. If the employer applies the coverage rules separately to the portion of a plan that benefits only employees who satisfy age and service conditions lower than the greatest conditions

permissible under section 410(a), this portion is then disaggregated from the portion benefiting those employees who have met the greatest age and service conditions permissible. This is, in effect, permissive disaggregation.

4. The portion of a plan benefiting employees of one QSLOB is disaggregated from portions of the plan benefiting employees of other QSLOBs. However, see Part II for an exception where a plan is being tested on an employer-wide basis.

5. The portion of a plan benefiting collectively bargained employees is disaggregated from the portion benefiting noncollectively bargained employees. See Part V for the definition of collectively bargained employee. (Do not check line a. "yes" merely because the plan is disaggregated under this rule. The collectively bargained portion of the plan automatically satisfies the coverage and nondiscrimination requirements.)

6. Plans benefiting the employees of more than one employer (multiemployer and multiple employer plans) are disaggregated along employer lines. Each employer's separate disaggregated plan must then satisfy the coverage and nondiscrimination requirements with reference only to that employer's employees.

When a plan is disaggregated as a result of the rules in paragraphs 4., 5., or 6., special rules apply with respect to employees who change status so that they move from one portion of the plan to another. These rules permit certain accruals or allocations for these employees that would otherwise be taken into account under one separate disaggregated plan to be taken into account under another separate disaggregated plan.

1.410(b)-7(c)

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line b. If the plan is disaggregated, aggregated, or restructured, the employer must submit a schedule (Demo 4) that provides the following information:

1. an explanation of the basis of the disaggregation, aggregation, or restructuring;

2. an identification of the aggregated, separate disaggregated, or restructured component plans; and

3. a demonstration of how any restructured component plans satisfy the minimum coverage requirements as if they were separate plans.

Check that the basis for any disaggregation is correct and

conforms to the categories in line a. In the case of permissive aggregation, make sure that the employer is not aggregating plans with different plan years or plans that may not be aggregated, as described above.

If the plan is being restructured, the employer may select the groups of employees that will form the basis of the restructuring, but check that each component consists of all the allocations or accruals and other BRFs provided to the selected group, that each employee is assigned to a particular component, and that components do not overlap.

A demonstration that a restructured component separately satisfies coverage should be made in accordance with the guidelines in Part V. (Remember, the plan as a whole must still satisfy coverage.) However, certain special rules apply. In general, a component will satisfy the average benefit percentage test (discussed in Part V) if the whole plan passes this test. Other special rules apply regarding the application of the average benefit percentage test with respect to plans benefiting both collectively bargained and noncollectively bargained employees and plans with early retirement window benefits. Note also that if the employer is using the QSLOB rules for purposes of coverage and nondiscrimination, the employer's demonstration that the restructured component plans satisfy section 410(b) as if they were separate plans must include a demonstration that each component satisfies the gateway test. Refer to Part II, lines b. and c., for a further discussion of the application of section 410(b) when the employer is using the QSLOB rules.

1.401(a)(4)-9(c)

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line c. If the plan is disaggregated, check that the employer has submitted coverage and nondiscrimination information (including demonstrations, if applicable) for each separate disaggregated plan (other than any separate disaggregated plan that benefits only collectively bargained employees.)

If the plan is permissively aggregated with another plan, make sure that the coverage and nondiscrimination information and demonstrations submitted reflect the terms of and the participants in the aggregated plan. If the plan is a DB/DC plan, make sure that the employer has identified the plan as a general test (not safe harbor) plan, and that any demonstration of the general test reflects the special rules that apply to these plans. (See Part X.)

If the plan is restructured, check that the nondiscrimination requirements (including the availability of

BRFs discussed in Part VI) are addressed separately with respect to each component. Also, ensure that section 401(k) or 401(m) plans are not being restructured.

V. COVERAGE

A qualified plan generally must satisfy either the "ratio percentage test" described in section 410(b)(1)(B) of the Code, or the "average benefit test" described in section 410(b)(2). (Certain nonelecting church plans may be allowed to satisfy the coverage requirements as they were in effect prior to ERISA.)

When an employer files a determination letter application, the employer must indicate whether the plan is meeting coverage on the basis of the ratio percentage test or the average benefit test. If the plan is meeting coverage on the basis of the ratio percentage test, the employer must provide a demonstration on Form 5300 or Form 5307. If the employer is using the average benefit test, the employer may elect to submit a demonstration (which should be identified as Demo 5) or to receive a caveated letter.

The minimum coverage requirements apply to both current and former employees. However, the coverage of former employees is not an issue in defined contribution plans; therefore, line c., which discusses the coverage of former employees, does not apply to defined contribution plans.

The minimum coverage requirements must be satisfied using a daily, quarterly, or annual testing option for the plan year, which is the same option used to meet section 401(a)(4) for the plan year. Plan provisions and other relevant facts as of the last day of the plan year are applied to determine which employees benefit for such plan year. If the daily testing option is used, the plan satisfies 410(b) for a plan year if it satisfies the minimum coverage requirements on each day of the plan year, looking only to that day to determine employees and former employees. Under the quarterly testing option, section 410(b) is deemed satisfied for the plan year if the plan meets the minimum coverage requirements on one representative day in each quarter of the year, looking only to those four days to determine employees and former employees. Under the annual testing option (which must be used for section 401(k) and section 401(m) plans and average benefit plans), a plan is deemed to satisfy section 410(b) for the plan year if it satisfies the minimum coverage requirements as of the last day of such plan year; however, the whole year is looked at to determine employees and former employees. A plan that fails the minimum coverage requirements for the plan year may be retroactively amended by the 15th day of the 10th month following such year to satisfy section 410(b) by, for example, expanding coverage.

Rev. Proc. 93-42 allows employers to substantiate compliance with the nondiscrimination rules (including the minimum coverage requirements) on the basis of the employer's workforce on a single day during the plan year (snapshot day), provided that day is reasonably representative of the employer's workforce and the plan's coverage throughout the year. Even though a favorable determination letter may not be relied on with respect to the use of the substantiation guidelines in Rev. Proc. 93-42, employers may submit coverage and nondiscrimination demonstrations that are the result of single day "snapshot" testing. Rev. Proc. 93-42 also provides that the use of snapshot testing may overstate coverage in plans that have minimum service requirements for accruals or allocations (e.g., 1000 hours of service or employment on the last day of the plan year). Rev. Proc. 93-42 further provides that to compensate for this, an adjustment must be made to the section 410(b) test and provides that an adjustment of 5 percent (i.e., 70 percent becomes 73.5 percent) for a 1,000 hour rule and an adjustment of 10 percent (i.e., 70 percent becomes 77 percent) for a last day rule (or for a combination of a last day and another minimum service rule) will be treated as safe harbors.

Because a favorable determination letter is not a determination regarding the use of the substantiation guidelines in Rev. Proc. 93-42, the specialist generally should not question the use of snapshot testing (if this is evident in the application) or any adjustments that the employer has made to the section 410(b) test on account of the use of snapshot testing.

Where there has been a merger or stock or asset acquisition or disposition and as a result there is a change in the make up of the employer (i.e., the section 414(b), (c), (m), and (o) employer), a special transition rule applies. Under this transition rule, a plan of the employer may be treated as satisfying the minimum coverage requirements during a transition period following the transaction if it satisfied section 410(b) immediately before the transaction and there has been no significant change in the plan's coverage aside from the transaction. The transition period begins with the transaction and ends with the end of the first plan year beginning after the transaction.

If the adopting employer is a member of an affiliated service group, a member of a controlled group of corporations, or one of several trades or businesses under common control, then the employees of all these employers must generally be taken into account in determining whether the coverage requirements are satisfied. However, for an exception to this rule, refer to Part II, regarding employers that treat themselves as operating QSLOBs.

1.410(b)-2 through -10

See IRC sections 414(b) and (c) and section 1.414(c)-1 through -5 of the Regulations to determine whether the entities are members of a controlled group of corporations or trades or businesses under common control, section 414(m) and section 1.414(m)-1 through -4 of the Proposed Regulations regarding whether entities are members of an affiliated service group.

In addition, any leased employee of the adopting employer or any other member of an affiliated service group, controlled group of corporations, or group of trades or businesses under common control of which the adopting employer is a part shall be treated as an employee of the adopting employer, unless leased employees do not constitute more than 20 percent of the recipient's nonhighly compensated workforce, and the employee is covered by a money purchase plan providing: (1) a nonintegrated employer contribution rate of at least 10% of compensation, (2) immediate participation, and (3) full and immediate vesting. See section 414(n) of the Code and Notice 84-11, 1984-2 C.B. 469, to determine whether an individual is a leased employee.

Mandatory Disaggregation and Permissive Aggregation

Certain plans are required to be disaggregated, and each separate disaggregated plan that results must separately satisfy the coverage requirements. In some circumstances, employers may aggregate two or more plans and treat them as a single plan for coverage purposes. For purposes of satisfying the nondiscrimination requirements, employers may restructure a single plan into separate component plans. When this is done, the plan and each separate component plan must separately satisfy the coverage requirements. See Part V for a discussion of these rules.

1.410(b)-7
1.401(a)(4)-9(c)

This section of the worksheet does not apply to the following plans (other than a plan subject to the requirements of section 403(b)(12)(A)(i)):

1. a church plan, unless the plan administrator makes an irrevocable election under IRC 410(d) to have the coverage

requirements apply to the plan
2. a plan which has not at any time after September 2, 1974, provided for employer contributions, and
3. a plan established by a society, order or association described in Code section 501(c)(8) or (9), if no part of the contributions under the plan are made by employers of participants in the plan.

These plans are subject to the requirements of section 401(a)(3) as in effect on September 1, 1974. If the employer has correctly indicated that it is subject to the pre-ERISA coverage requirements, complete only line a. of this Part and answer line a. "yes" unless it is determined that the plan fails to satisfy the pre-ERISA coverage requirements.

1.410(b)-2(e)
1.410(d)-1

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line a. A plan satisfies the "ratio percentage test" of IRC section 410(b)(1)(B) with respect to employees if the percentage of the employer's nonhighly compensated employees (nonHCE) who benefit under the plan divided by the percentage of highly compensated active employees (HCE) who benefit under the plan is at least 0.70. (percentages are calculated to the nearest hundredth.) That is,

$$\frac{\%\text{ of nonHCE benefiting}}{\%\text{ of HCE benefiting}} = 0.7$$

Example: Employer Y has 100 employees. Thirty of these employees are highly compensated employees under IRC section 414(q). Y maintains a qualified plan (Plan A) that benefits 15 of the 30 HCE, that is, 50 percent of Y's HCE. Plan A also benefits 25 of the 70 nonHCE, or 35.71 percent of all nonHCE. Plan A satisfies the ratio percentage test because the percentage of nonhighly compensated active employees benefiting (35.71 percent) is at least 70 percent of the percentage of highly compensated employees benefiting (50 percent).

$$\frac{35.71\%\text{ of nonHCE}}{50\%\text{ of HCE}} = 0.7142$$

The regulations merged the percentage test of IRC section 410(b)(1)(A) and the ratio test of IRC section 410(b)(1)(B) into the "ratio percentage test" because a plan that satisfies the percentage test of IRC section 410(b)(1)(A) (at least 70 percent of all nonhighly compensated employees benefit) will necessarily also satisfy the ratio test.

1.410(b)-2

An employee is an individual who performs services for the employer. An employee becomes a former employee on the day after the day on which he or she stops performing services for the employer. Thus, one employee may be both an employee and a former employee for the same plan year. A former employee is treated as an employee with respect to allocations that are taken into account under the defined contribution plan nondiscrimination in amount general test and with respect to increases in accrued benefits under a defined benefit plan based on ongoing service or compensation credits (including imputed service or compensation.)

1.410(b)-9

The definition of highly compensated employee is provided in IRC section 414(q). If a plan includes a definition of highly compensated employee the specialist should refer to Alert Guidelines #11 or #12 to determine if the definition satisfies the requirements of section 414(q). The simplified definition of highly compensated employee provided under section 4 of Rev. Proc. 93-42 and the guidance under Rev. Proc. 95-34 does not apply for years beginning after December 31, 1996. A nonhighly compensated employee is any employee who does not fit within the definition of highly compensated employee.

A nonhighly compensated employee is any employee who does not fit within the definition of highly compensated employee. Under the family aggregation rules of section 414(q)(6), a highly compensated employee who is a 5-percent owner or one of the ten most highly compensated employees and any family member of the highly compensated employee who is also an employee of the employer are to be treated as a single highly compensated employee. If any member of such group is benefiting under the plan, the deemed single employee is treated as benefiting under the plan.

Note that under a special rule in section 1.410(b)-2(b)(5), if the employer has no nonhighly compensated employees the plan will be deemed to satisfy the coverage tests of IRC section 410(b). Also, under 1.410(b)-2(b)(6), if no highly compensated employees benefit under the plan section 410(b) will be deemed satisfied.

1.410(b)-2(b)(5), (6) and 1.410(b)-8(b), Notice 97-75

Excludable Employees

In testing a qualified plan for coverage, except as provided in 4., below, the following employees must be disregarded:

1. Minimum Age and Service: All employees who have not attained age 21 and completed one year of service, or two years in the case of a plan with immediate vesting, are disregarded in testing a qualified plan which has such eligibility requirements. However, if a plan benefits any such otherwise excludable employee, it must test coverage based on the minimum age and service requirements under the plan. In the alternative, employees who have not attained age 21 and completed one year of service but have attained the plan's minimum age and service requirements may be tested for coverage as if they were in a separate plan. The rest of the plan participants may then be tested for coverage disregarding employees who have not attained age 21 or do not have one year of service. A plan may continue to treat employees who have met the minimum age and service requirements as excludable until the first plan entry date on which any employee with the same age and service would be eligible to commence participation.

410(b)(4)
1.410(b)-6(b) and -7(c)(3)

2. Collective Bargaining Unit Employees: For the purposes of testing a plan or portion of a plan covering noncollectively bargained employees for coverage, employees who are included in a unit of employees covered by an agreement (within the meaning of section 7701(a)(46)) that the Secretary of Labor finds to be a collective bargaining agreement between employee representatives and one or more employers are excluded if there is evidence that the retirement benefits were the subject of good faith bargaining between such employee representatives and such employer or employers. However, if more than 2 percent of the employees who are covered under a collective bargaining agreement are professional employees within the meaning of section 1.410(b)-9 of the regulations, all employees covered under such collective bargaining unit are treated as noncollective bargaining unit employees. Special rules apply with respect to employees who perform services both as collectively bargained and noncollectively bargained employees, and also with respect to employees in multiemployer plans.

1.410(b)-6(d)

3. Nonresident Aliens: Nonresident aliens (within the meaning of section 7701(b)(1)(B)) who receive no earned income (within the meaning of section 911(d)(2)) from the employer that constitutes income from sources within the United States (within the meaning of section 861(a)(3)) are excluded for the purposes of testing any qualified plan of the employer for coverage. In addition,

nonresident aliens who do have income described in the previous sentence are also excluded if, pursuant to a treaty, it is exempt from U.S. income tax and all such aliens are excluded.

1.410(b)-6(c)

4. Last Day and < 501 Hours of Service: Employees who fail to receive an allocation or to accrue a benefit solely because they fail to satisfy a minimum hour of service or last day requirement under the plan may be excluded for the purposes of testing the plan for coverage if they do not have more than 500 hours of service and they are not employed on the last day of the plan year. Employees who have more than 500 hours of service or who are employed on the last day of the plan year may not be excluded merely because they are not employed on the last day of the plan year or did not have sufficient hours of service under the plan to accrue a benefit or receive an allocation for the plan year. Thus, even though these employees are ineligible to benefit under the plan for a plan year, they are taken into account in determining the percentage of employees who do benefit. For example, if an employer's profit-sharing plan required 1,000 hours of service in order to get an allocation from the plan and 10 of the employer's employees have more than 500 but less than 1,000 hours of service, the 10 employees will not be excludable employees because they have less than 1,000 hours of service and they will be treated as employees who do not benefit for the purposes of the coverage tests.

For a plan using elapsed time, "91 consecutive days" or "3 consecutive calendar months" should be substituted for "500 hours of service" in the preceding paragraph. Adjustment is also required if the plan uses one of the equivalencies for crediting hours of service in DOL Regs. section 2530.200(b)-3.

1.410(b)-6(f)

5. Employees of Qualified Separate Lines of Business: In testing a plan that benefits employees of an employer's QSLOB (within the meaning of section 414(r) and the regulations thereunder), employees of the employer's other QSLOBs are excluded. However, this rule does not apply in determining whether a plan satisfies the gateway test that requires the plan to satisfy the nondiscriminatory classification requirement on an employer-wide basis. It also does not apply when a plan is being tested as an employer-wide plan. See Part II.

1.410(b)-6(e)

6. Former Employees Treated as Employees: Formerly nonhighly compensated employees who are treated as employees under a

defined benefit plan because of ongoing service or compensation credits after cessation of service (including imputed service or compensation) may be excluded.

1.410(b)-6(i)

7. Employees of Certain Governmental or Tax-Exempt Entities: If a section 401(k) plan, or a section 401(m) plan provided under the same general arrangement as a section 401(k) plan, is maintained by an employer that is part of a controlled group which contains governmental or tax-exempt entities which are precluded from adopting a section 401(k) plan by section 401(k)(4)(B), then employees who are so excluded from participating are excluded in testing for coverage but only if more than 95% of the employees who are not statutorily ineligible to participate benefit under the plan. Note that Notice 96-64 allows tax-exempt entities to continue to use this rule only through the 1997 plan year. Tax-exempt entities may not avail themselves of this rule in plan years after the 1997 plan year.

1.410(b)-6(g)

Benefiting

In general, an employee is treated as benefiting for the purposes of the coverage tests, only if the employee receives an allocation of contributions or forfeitures, or accrues a benefit under the plan for the plan year. However, employees are treated as benefiting if they fail to receive an allocation of contributions and/or forfeitures, or to accrue a benefit solely because the employee is subject to plan provisions that uniformly limit plan benefits, such as a provision for maximum years of service, maximum retirement benefits, or application of offsets or fresh start wear-away formulas. Limits designed to satisfy section 415 are disregarded for purposes of determining if an employee is benefiting under a defined benefit plan. Such limits may also be disregarded in determining if an employee is benefiting under a defined contribution plan, provided this is done on a consistent basis for all employees. Employees are not treated as benefiting solely because of increases in accrued benefits that result from increases in the section 415 limits due to the adjustment section 415(d)(1) or additional service credited for section 415 purposes. (Plan provisions implementing section 415 may not be disregarded, however, if the employer is demonstrating compliance with the defined benefit general test and is taking these provisions into account in determining accrual rates.) Special rules apply in the case of target benefit plans and section 412(i) plans.

A defined contribution plan under which no employee receives

an allocation of contributions or forfeitures for the plan year is treated as satisfying section 410(b) for such plan year because no highly compensated employee is benefiting. Thus, a defined contribution plan for which contributions cease and for which no forfeiture can be allocated satisfies the coverage rules. Similarly, a defined benefit plan under which no employee accrues any additional benefits for the plan year will satisfy section 410(b) for the plan year. However, if the plan is required to provide top-heavy accruals for the plan year, or if the plan takes future compensation increases into account in determining accrued benefits, the plan will have to be tested for coverage.

An employee is treated as benefiting under a plan to which elective contributions or after-tax employee contributions and matching contributions subject to section 401(k) or 401(m) may be made if the employee is currently eligible to make such elective or after-tax employee contributions, or to accrue a matching contribution, whether or not the employee actually makes or receives such contributions.

1.410(b)-3

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line b. Complete this line b. only if the employer has requested a determination that the plan satisfies the average benefit test. If the employer has requested such a determination, the employer is required to submit a demonstration that this test is satisfied. This demonstration should be identified as Demo 5.

The average benefit test is a two part test. First, the plan must satisfy the nondiscriminatory classification test. Second, the plan must satisfy the average benefit percentage test.

The explanation that follows relates to the nondiscriminatory classification test only. To determine if the plan satisfies the average benefit percentage test, refer to the discussion of this test in the appendix in Explanation 5C. The nondiscriminatory classification test is described here rather than in the appendix because this test may be used to determine whether the plan satisfies certain nondiscrimination requirements, such as the requirement that benefits, rights, and features be made available in a nondiscriminatory manner. See Part VI.

410(b)(2)
1.410(b)-2(b)(3)

(i) In order to satisfy the nondiscriminatory classification test, the plan must meet two requirements. First, the classification of employees who benefit under the plan that is established by the employer must be reasonable. Second, it must be nondiscriminatory.

A reasonable classification is one that is both reasonable and based on objective business criteria that identify the categories of employees who will benefit, such as salaried or hourly. Enumeration by name or other criteria with the same effect is not reasonable.

Determining if a classification is nondiscriminatory may involve both a mechanical and a facts and circumstances analysis.

First, the classification will be nondiscriminatory if the plan's ratio percentage is at least equal to the employer's safe harbor percentage. (See line a. for the definition of ratio percentage, including the meaning of benefiting and excludable employee.) An employer's safe harbor percentage is 50 percent, reduced by 3/4 of one percent for each whole percent by which the nonhighly compensated employee (NHCE) concentration percentage exceeds 60 percent. The NHCE concentration percentage is the percentage of all the employees of the employer who are nonhighly compensated. The safe harbor percentages for the various possible NHCE percentages are shown in the table below.

Second, if the plan's ratio percentage is less than the safe harbor percentage, the classification will nevertheless be nondiscriminatory if the ratio percentage is at least equal to the employer's unsafe harbor percentage and the Service determines, on the basis of facts and circumstances, that the classification is nondiscriminatory. Thus, in this situation, the specialist will need to look at the employer's particular facts to make this determination.

An employer's unsafe harbor percentage is 40 percent, reduced by 3/4 of one percent for each percent by which the NHCE concentration percentage exceed 60 percent. The unsafe harbor percentage is never less than 20 percent.

Among the facts and circumstances the specialist should consider in determining whether a classification that falls between the safe and unsafe harbor percentages is nondiscriminatory are the following:

a. the business reason for the classification (reducing benefits costs is not relevant);

b. the percentage of all employees benefiting under the plan (the higher the better);

c. whether the plan benefits representative numbers of employees in each salary range;

d. how close the plan's ratio percentage is to the employer's safe harbor percentage; and

e. the extent to which the plan's average benefit percentage exceeds 70 percent.

No one fact is determinative.

Table of Safe and Unsafe Harbor Percentages

NHCE Concentration Percentage	**Safe Harbor Percentage**	**Unsafe Harbor Percentage**
0-60	50.00	40.00
61	49.25	39.25
62	48.50	38.50
63	47.75	37.75
64	47.00	37.00
65	46.25	36.25
66	45.50	35.50
67	44.75	34.75
68	44.00	34.00
69	43.25	33.25
70	42.50	32.50
71	41.75	31.75
72	41.00	31.00
73	40.25	30.25
74	39.50	29.50
75	38.75	28.75
76	38.00	28.00
77	37.25	27.75
78	36.50	26.50
79	35.75	25.75
80	35.00	25.00
81	34.25	24.25

82	33.50	23.50
83	32.75	22.75
84	32.00	22.00
85	31.25	21.25
86	30.50	20.50
87	29.75	20.00
88	29.00	20.00
89	28.25	20.00
90	27.50	20.00
91	26.75	20.00
92	26.00	20.00
93	25.25	20.00
94	24.50	20.00
95	23.75	20.00
96	23.00	20.00
97	22.25	20.00
98	21.50	20.00
99	20.75	20.00

1.410(b)-4

(ii) See the appendix in Explanation 5C to determine whether the plan satisfies the average benefit percentage test.

1.410(b)-5

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line c. A plan must separately satisfy the minimum coverage requirements with respect to its former employees. A plan will satisfy the minimum coverage requirements with respect to former employees if the facts and circumstances indicate that the group of former employees benefiting under the plan does not discriminate significantly in favor of highly compensated former employees. Employers are not required to submit demonstrations regarding this requirement when a determination letter application is filed. Line V.c. should be checked "yes" unless facts present with the application indicate that the plan may not satisfy this requirement.

Among the facts and circumstances taken into account is the group of nonexcludable former employees who do not benefit under the plan) employees. An employee becomes a former employee on the day after the day on which he or she stops performing services for the employer. Thus, one employee may be both an employee and a former employee for the same plan year. A former employee is treated as benefiting for a plan year if an accrual or allocation arises with respect to the employee's status as a former employee (such as an ad hoc cost of living adjustment provided to former employees).

A former employee who was an excludable employee at the time of termination under the rules described under line V.a. may be excluded even if benefiting in the current plan year. The employer may elect to exclude former employees who became former employees before January 1, 1984, or the tenth calendar year preceding the year in which the current plan year begins, and before the earliest calendar year in which any currently benefiting former employee became a former employee.

(Because section 415 limits annual additions to a defined contribution plan to 25% of a participant's compensation, defined contribution plans generally will not benefit former employees. Note that an employee who has ceased employment with an employer but receives allocations based on imputed compensation is tested as an employee, not a former employee.)

A plan automatically satisfies section 410(b) with respect to its former employees if it benefits no highly compensated former employees or has no nonhighly compensated former employees.

1.410(b)-2(c), -3(b), -6(h), -8(a) and -9

VI. Benefits, Rights, and Features

One of the requirements a plan must satisfy in order to meet the nondiscrimination requirement of section 401(a)(4) is that all benefits, rights, and features (BRFs) provided under the plan must be made available in the plan in a nondiscriminatory manner. BRFs include all optional forms of benefit, ancillary benefits, and other rights and features available to any employee under the plan. A BRF is made available in a nondiscriminatory manner if it meets both a current availability requirement and an effective availability requirement.

A BRF satisfies the current availability requirement if it is currently available to a group of employees that constitutes a nondiscriminatory coverage group under the minimum coverage rules of section 410(b). A BRF satisfies the effective availability requirement if, on the basis of facts and circumstances, it is available to a group of employees that does not substantially favor highly compensated employees. Special rules allow certain BRFs to be treated as satisfying these requirements.

1.401(a)(4)-1(b)(3)
1.401(a)(4)-4

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line a. Because the effective availability requirement is essentially an anti-abuse rule, determination letters may not be relied on as to whether any BRF satisfies this requirement and specialists should not review a plan with regard to this requirement. In general, determination letters are also caveated with respect to the current availability requirement. However, employers may request the Service to determine whether specific BRFs under the plan satisfy the current availability requirement. When an employer files a determination letter request for a plan, it must indicate whether it is requesting a determination regarding the current availability of BRFs.

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lines b. and c. If the employer requests a determination regarding the current availability of BRFs, the employer is required to specify each BRF for which it is seeking such a determination and to demonstrate that each such BRF satisfies the current availability requirement. (This should be identified in the employer's application as Demo 3.) Only those BRFs that are specified by the employer should be considered. Some employers may ask for a determination that a plan provision does not create a separate BRF that must separately meet the nondiscriminatory availability requirements. In this case, if it is determined that the provision does give rise to a separate BRF, the employer should be asked to demonstrate that the BRF satisfies the current availability requirement.

The instructions for Schedule Q (Form 5300) contain guidelines that employers may follow in making this kind of demonstration. The explanation that follows tracks the guidelines in the instructions for Schedule Q.

1.a. and b. Identification of the BRF

In reviewing this information, the specialist should determine that the specified BRF is a separate BRF within the meaning of the regulations (however, also see 2. below) and that all terms that could affect the availability of the BRF to employees have been identified.

Each different optional form of benefit, ancillary benefit, and other right and feature available to any employee under the plan is generally a separate BRF that must separately meet the nondiscriminatory availability requirements. (See 2., below, for circumstances in which BRFs may be permissively aggregated for this purpose.)

An optional form of benefit is any distribution alternative (including the normal form of benefit) that is available with respect to accrued benefits, early retirement benefits, and retirement-type subsidies. Different optional forms exist if a distribution alternative is not payable on substantially the same

terms as another alternative. Such differences can arise from any terms affecting the value of the optional form, such as timing, commencement, election rights, and actuarial assumptions.

Ancillary benefits generally include, but are not limited to the following:

Social Security supplements (other than qualified Social Security Supplements, as defined in the regulations)
Disability benefits not in excess of the qualified disability benefit described in section 411(a)(9)
Ancillary life and health insurance
Death benefits
Plant shut-down benefits

Other rights and features include:

Loans
Self-direction investment rights
Right to a given form of investment
Right to invest in employer securities
Right to make each rate of elective and employee contributions
Right to each rate of matching contributions
Right to purchase additional ancillary benefits
Right to make rollovers and transfers

Different ancillary benefits (or rights and features) exist if an ancillary benefit (or right or feature) is not available on substantially the same terms as another ancillary benefit (or right or feature).

A distribution alternative will not fail to be a single optional form of benefit simply because benefit or allocation formulas, accrual methods, or vesting schedules pertaining to the accrued benefit that is paid in the form of the distribution alternative are different for different employees to whom the distribution alternative is available. Differences in the normal retirement ages of employees, however, are taken into account in determining whether a distribution alternative constitutes one or more optional forms of benefit.

1.401(a)(4)-4(a)
1.401(a)(4)-4(e)

1.c. Conditions disregarded in determining current availability

The determination of whether a BRF is currently available is based on the current facts and circumstances of the employee, except that conditions specified in the regulations

including conditions requiring a specific vesting percentage, termination of employment, death, disability, family status, hardship, execution of a covenant not to compete, and, in the case of optional forms of benefit and social security supplements only, attainment of specified age and/or service (other than time-limited age or service conditions) are disregarded. Also disregarded is a loan condition requiring a minimum account balance for a minimum loan amount (not in excess of $1,000). If a plan provides for mandatory cash-outs of all terminated employees with vested accrued benefits not in excess of $5,000 (or lower stated amount), it can also disregard a condition that requires the employee to have a vested accrued benefit of that amount in order to receive a benefit, right or feature. Special rules also apply in the case of multiemployer plans.

1.401(a)(4)-4(b)(2)

1.d. Unpredictable contingent event benefits

Although current availability is generally determined on current facts and circumstances, the current availability of an unpredictable contingent event benefit, such as a plant shut-down benefit, is determined as if the event has occurred, disregarding any age or service conditions for eligibility for the benefit (other than time-limited conditions).

1.401(a)(4)-4(d)(7)

1.e. Early retirement window benefits

There is a special rule for determining the current availability of early retirement window benefits. For this purpose, an early retirement window benefit is an early retirement benefit or subsidy or other BRF that is available only to employees who terminate employment during a "window" period of not more than one year set by the plan. Under this special rule, an early retirement window benefit is treated as not being available to an employee for a plan year other than the first plan year in which the benefit is currently available to the employee. If the specified benefit is an early retirement window benefit, the specialist should ensure that the employer's demonstration shows that this special testing rule has been properly applied.

1.401(a)(4)-4(d)(3)

2. Permissive aggregation

An employer may permissively aggregate an optional form of benefit, ancillary benefit, or other right or feature with another optional form of benefit, ancillary benefit, or other

right or feature, respectively, and treat the combined BRF as a single BRF. Aggregation is permitted only if

(a) one of the two BRFs is inherently of equal or greater value than the other, and

(b) the BRF that is of inherently equal or greater value must separately satisfy nondiscriminatory availability.

If a specified benefit for which the employer is providing a demonstration is an aggregated benefit, the employer must also demonstrate that the requirements in (a) and (b) have been satisfied.

A BRF is of inherently equal or greater value than another only if it is impossible under any circumstances for an employee to receive less under the first BRF than under the second. For example, a fully subsidized joint and survivor annuity is of inherently equal or greater value than a normal form straight life annuity but is not of inherently equal or greater value than a lump sum that is actuarially equivalent to the normal form because under some circumstances the participant would receive less under the fully subsidized QJSA than under the lump sum.

1.401(a)(4)-4(d)(4)

3. Employees to whom the BRF is available

The employer must describe the group of employees to whom the BRF is currently available (as determined by the preceding rules) and must indicate whether this group includes any "frozen participants." Frozen participants are nonexcludable employees with accrued benefits who are not currently benefiting under the plan. A plan must satisfy the nondiscriminatory availability requirements separately with respect to any frozen participants. See 5., below.

1.401(a)(4)-4(d)(2)

4. Satisfaction of the current availability requirement

The employer's demonstration must show that the specified BRF satisfies current availability by being currently available to a nondiscriminatory coverage group or by meeting one of the special rules, as described below.

a. Ratio percentage and nondiscriminatory classification tests

The BRF will satisfy current availability if the employer's demonstration shows that the group of employees to whom the BRF

is currently available satisfies section 410(b) without regard to the average benefit percentage test. That is, the group must satisfy the ratio percentage test or the nondiscriminatory classification test. See Part V for definitions of these terms and for guidance in determining whether one of these tests has been satisfied. Note that if the employer is using the QSLOB rules for purposes of coverage and nondiscrimination, the employer's demonstration that the group of employees to whom the BRF is currently available satisfies section 410(b) must include a demonstration that the availability of the BRF satisfies the gateway test. Refer to Part II, lines b. and c., for a further discussion of the application of section 410(b) when the employer is using the QSLOB rules.

1.401(a)(4)-4(b)(1)

b. Prospectively eliminated benefits

If the BRF has been prospectively eliminated with respect to benefits accrued after a certain date, but satisfied section 410(b), as described above, as of the elimination date, it will be treated as satisfying current availability for all periods after the elimination date. Therefore, if the BRF is one that has been prospectively eliminated, the employer's demonstration should be based on the availability of the BRF as of the elimination date. Note that the regulations contain special rules for determining whether a BRF has been prospectively eliminated, but, generally, a BRF is eliminated with respect to benefits accrued after a given date if the amount or value of the BRF depends solely on the amount of the accrued benefit as of the elimination date (including subsequent income, etc., in the case of a defined contribution plan).

1.401(a)(4)-4(b)(3)

c. Mergers and acquisitions

If a BRF is available only to a group of employees who were "acquired" as a result of a merger or acquisition, it may satisfy the current availability requirement under a special rule. This special rule operates to provide that if the BRF satisfies current availability under the acquiring employer's plan, taking into account all of that employer's nonexcludable employees (including the acquired employees), after the merger or acquisition, it will be treated as satisfying current availability thereafter. This rule is available if the BRF is available under the employer's plan on the same terms as it was available under the other employer's plan. The effect of this rule is that even though the acquired group of employees may at some point after the merger no longer constitute a nondiscriminatory coverage group, this will not taint the BRF.

If the employer is using this rule, it should demonstrate that as of a date selected by the employer as the last date by which employees can come into the acquired group, the BRF satisfies the ratio percentage or nondiscriminatory classification test, taking into account all the employer's nonexcludable employees.

1.401(a)(4)-4(d)(1)

d. Spousal benefits

If the employer is permissively aggregating plans for purposes of coverage and nondiscrimination (see Part V), any QJSA, QPSA, or required spousal death benefit (under plans exempt from the QJSA requirement) in the aggregated plan is generally treated as satisfying the nondiscriminatory availability requirements and a demonstration of actual availability is not necessary. This rule does not apply to subsidized benefits under a defined benefit plan.

1.401(a)(4)-4(d)(5)

e. ESOPs

Demonstrations of actual availability are not required in the case of certain diversification rights, distribution options, or restrictions that apply to ESOPs. BRFs arising from these rights, options, and restrictions are treated as satisfying the nondiscriminatory availability requirements.

1.401(a)(4)-4(d)(6)

f. DB/DC plans

If the employer is permissively aggregating defined benefit and defined contribution plans (see Part IV concerning DB/DC plans), a BRF that is provided only under the DB plan(s) or only under the DC plan(s) in the DB/DC plan is deemed to satisfy current availability if it is currently available to all NHCEs in all plans of that type. However, this special rule does not apply to the following types of BRFs: single sum benefits, loans, ancillary benefits, and benefit commencement dates(including the availability of in-service withdrawals).
1.401(a)(4)-9(b)(3)

5. Frozen participants

If the employer has indicated that the BRF is provided to

frozen participants, it must separately demonstrate that it satisfies the nondiscriminatory availability requirement with respect to these participants. Special rules apply to determine that this requirement is met. One rule provides that the BRF will satisfy availability if there has been no change in the current plan year with respect to its availability to any frozen participant. Even if this rule is not met, the BRF will still pass if the employer's demonstration shows that the change in availability has been made in a nondiscriminatory manner, the group of frozen participants to whom the BRF is available constitutes a nondiscriminatory coverage group (taking into account all nonexcludable employees), or the group of employees to whom the BRF is available continues to constitute a nondiscriminatory coverage group when the frozen participants are counted as currently benefiting employees.

6. Elimination of age 70 1/2 distribution option

An employer that decides to eliminate the availability of a preretirement optional form of benefit for a participant (other than a 5-percent owner) who attains age 70 1/2 after a specified year has relief from the applicable sections of section 401(a)(4) under Notice 97-75. A preretirement age 70 1/2 distribution is an optional form of benefit under which benefits payable in a particular distribution form (including any modifications that may be elected after benefit commencement) commence during the 70 1/2 period (beginning January 1 of the year in which the employee attains age 70 1/2 and ending on the April 1 of the following year) prior to the employee's retirement from employment with the employer maintaining the plan. An optional form of benefit available to a 5-percent owner at age 70 1/2 and retirement and to other participants only at retirement will be treated as the same optional form of benefit for purposes of testing the nondiscriminatory availability of benefits, rights, and features. Additional relief is provided as stated in Notice 97-75. See Explanation #9 for additional discussion.

1.401(a)(4)-4(d)(2)

VII. PAST SERVICE AND SERVICE-CREDITING

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line a. A plan will not satisfy section 401(a)(4) if the timing of plan amendments, including amendments granting past service credit, have the effect of discriminating significantly in favor of highly compensated employees. For this purpose, a plan amendment includes establishment and termination. Past service credits include:

1. Benefits attributable to service prior to the time a new

plan is in effect.

2. Increases in existing benefits resulting from an employee's service prior to the effective date of a plan amendment.

3. Benefits attributable to service with another employer that may be taken into account in accordance with line b.

Whether the granting of past service significantly discriminates is generally a question of relevant facts and circumstances. These include the relative numbers of HCEs and NHCEs affected, their relative service and accrued benefits, and turnover. Also relevant are the relative benefits of employees and former employees who are not affected by the grant of past service but who would have been had the plan or amendment been in effect during the period for which past service credit is granted.

A plan amendment granting past service credit is deemed not to discriminate significantly in favor of highly compensated employees if the following conditions are satisfied:

1. the period for which the credit is granted does not exceed the 5 years immediately preceding the year in which the amendment first becomes effective,

2. the grant applies on a reasonably uniform basis to all employees,

3. the credit is determined under the current plan formula,

4. the service is service with the employer or a previous employer that may be taken into account under line b., and

5. the amendment is not part of a pattern of amendments that discriminates in favor of HCEs or former HCEs.

When the employer submits a determination letter request, the employer is required to indicate if a plan amendment, or (in the case of an initial determination) a plan provision provides for past service that does not satisfy the safe harbor. The employer should also attach a description of the nature of the past service, identifying the relevant plan provisions. This should be labeled Demo 7.

If there is a concern that the plan may not satisfy this requirement with respect to the granting of past service credit on establishment or amendment of the plan, the specialist may ask the employer to demonstrate that the timing of the amendment (or establishment of the plan) does not significantly discriminate in favor of HCEs.

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line b. A plan must be nondiscriminatory with respect to the manner in which service is credited under the plan. For this purpose service-crediting means service credited for each purpose under the plan, including benefit service, accrual service, vesting service, and eligibility service, and the nondiscrimination requirement must be separately satisfied for each purpose.

A plan is deemed to satisfy this requirement with respect to service credited for periods prior to 1994 under a plan provision adopted and in effect on February 11, 1993 that satisfied the nondiscrimination requirements then in effect.

Whether the manner in which the plan credits service is nondiscriminatory is a facts and circumstances determination. However, the manner in which service is credited for a particular purpose will deemed to be nondiscriminatory if each combination of service-crediting provisions applied for that purpose would satisfy the nondiscriminatory availability requirements if that combination were an other right or feature.

Generally, service for periods in which an employee did not perform services for the employer or in which the employee did not participate in the plan may not be taken into account in determining whether the nondiscrimination in amount requirement (see Parts X and XI) or the nondiscriminatory availability requirement (see Part VI) are satisfied, although the crediting of any service required by other qualification rules (e.g., section 411(a)) will not cause the plan to fail to satisfy this requirement. There are several exceptions to this general rule.

First, past service that satisfies line a. may be taken into account. For this purpose, past service is service for periods in which service was performed for the employer and in which the employee did not participate in the plan but would have had the plan (or the amendment extending coverage to the employee) been in existence.

Second, pre-participation service that meets certain requirements described below may be taken into account. Pre-participation service means years of service with the employer or a prior employer for periods before the employee commenced or recommenced participation in the plan, other than past service.

Third, imputed service that meets the requirements described below may be taken into account. Imputed service is any service credited for periods after the employee commenced participation in the plan while the employee is not performing services as an employee of the employer or while the employee is on a reduced

work schedule but receiving service credit that would not otherwise be credited under the general terms of the plan.

In order to be taken into account for purposes of nondiscrimination in amount or nondiscriminatory availability, pre-participation or imputed service must be provided under provisions that apply to all similarly situated employees and must be provided for legitimate business reasons. In addition, the provision must not by design or operation discriminate significantly in favor of highly compensated employees. This is a facts and circumstances determination.

When an employer submits a determination letter request, the employer is also required to indicate whether the plan provides for pre-participation or imputed service. If so, the employer is also required to describe the nature of the service, to indicate whether it is being taken into account for purposes of nondiscrimination in amounts testing (see Parts X and XI), and to identify the relevant plan provisions. This information should be labeled Demo 7.

If it is determined that the manner in which the plan credits service may be discriminatory, the employer may be asked to provide a demonstration that this requirement is satisfied.

1.401(a)(4)-11(d)

VIII. OTHER NONDISCRIMINATION REQUIREMENTS

Line a. All defined benefit plans must include provisions restricting benefits and distributions to avoid discrimination that may occur in the event of an early termination of the plan. The provisions that the plan must include are the following:

1. The plan must provide that, in the event of early termination, the benefit of any highly compensated employee or former highly compensated employee is limited to a benefit that is nondiscriminatory under section 401(a)(4).

2. The plan must provide that distributions made to any participant in a group that includes the top 25 most highly compensated current and former employees (restricted employees) is restricted to an amount that is not more than the amount that would be paid to the individual under a straight life annuity that is the actuarial equivalent of the employee's accrued benefit and any other benefits under the plan (other than a social security supplement), plus the amount of any social security supplement the participant is entitled to receive. This restriction does not apply if:

a. after payment of the benefit to the restricted employee, the value of plan assets equals or exceeds 110 percent of the value of current liabilities as defined in section 412(l)(7),

b. the value of the benefits for the restricted employee is less than 1 percent of the value of current liabilities before distribution, or

c. the value of the restricted employee's benefits does not exceed $5,000.

Rev. Rul. 92-76, 1992-38 I.R.B., holds that distributions of amounts that would otherwise exceed the new restrictions may be made provided the plan requires adequate security to guarantee any repayment of the restricted amount upon termination. For this purpose, the restricted amount is the excess of the "accumulated amount" of distributions to an employee over the "accumulated amount" of the payments that would have been paid under the restriction in paragraph 2, above. An "accumulated amount" is the amount of a payment increased by a reasonable rate of interest from the date of payment to the date of determination of the restricted amount.

Examples of plan provisions requiring adequate security are provisions that require an employee, at the time of distribution, to deposit in escrow property with a fair market value of at least 125% of the restricted amount or to post a bond or letter of credit in an amount equal to at least 100% of the restricted amount.
1.401(a)(4)-5(b)
Rev. Rul. 92-76

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line b. A qualified plan may not discriminate in favor of HCEs in the manner in which employees vest in their accrued benefits under a plan. This is a facts and circumstances determination.

For this purpose, the vesting schedules in sections 411(a)(2)(A) (five-year cliff) and (B) (three-to-seven-year graded) are treated as equivalent to each other. The two top heavy minimum vesting schedules are also treated as equivalent to each other.

The manner in which employees vest is deemed to be nondiscriminatory if each combination of plan provisions affecting nonforfeitability would satisfy the nondiscriminatory availability requirements if it were an other right or feature.
1.401(a)(4)-11(c)

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line c.(i) and (ii) A qualified plan must also satisfy the nondiscriminatory amount and availability requirements with respect to former employees. However, this requirement is generally relevant only in the case of benefits provided through an amendment that is effective in the plan year.

A plan will satisfy the nondiscriminatory amount requirement with respect to former employees if, based on all the facts and circumstance, the amounts of contributions or benefits provided to former employees do not discriminate significantly in favor of HCEs. A plan under which no former employee currently benefits is deemed to satisfy this requirement. Thus, only amendments to defined benefit plans adjusting former employees' benefits (e.g. COLA adjustments) are taken into account.

In making the determination of whether the amount of contributions or benefits provided to former employees discriminates significantly in favor of former HCEs, the rules of section 401(l) and the corresponding imputed disparity rules under section 401(a)(4) apply. Thus, in determining a former employee's cumulative disparity limit, the employee's annual disparity fractions as an employee must be taken into account. In addition, a former employee's permitted disparity rate is determined as of the age benefits commence, not when the employee receives the accrual for the current plan year. Where an amendment increasing benefits for former employees in pay status (including former HCEs) increases the disparity in the plan's benefit formula beyond the maximum permitted disparity adjusted for any reasonable approximation of the increase in the cost of living since the former employees commenced receiving benefits, the amendment will result in significant discrimination in favor of former HCEs.

Specialists may need to ask employers to show the relative numbers of HCEs and NHCEs who benefit as the result of a plan amendment where the amendment may cause the contributions or benefits under the plan to discriminate significantly in favor of former HCEs. For example, an amendment that increases the benefits of only those former employees in pay status who terminated employment after attaining early retirement age may be likely to benefit relatively more former HCEs than former NHCEs and a request for a demonstration from the employer would be appropriate.

A plan will satisfy the nondiscriminatory availability requirement with respect to benefits, rights, and features provided to former employees if any change in the availability to any former employee is applied in a manner that, based on all the facts and circumstance, does not discriminate significantly in favor of HCEs. If there is a question as to whether the plan may

fail to satisfy these requirements, the specialist may request a demonstration from the employer.

1.401(a)(4)-10

IX. FLOOR-OFFSET SAFE HARBOR TESTING METHOD

If the plan is a defined benefit plan that offsets the participant's accrued benefit by the value of the participant's account balance under another plan of the employer, the specialist should determine if the plans are part of a floor-offset arrangement that is intended to satisfy the requirements of the safe harbor testing method in the regulations.

This safe harbor allows the defined benefit plan to satisfy the unit credit safe harbor (see Part XI, below) or the general test for nondiscrimination in amounts (see Part X, below), disregarding the offset to the benefit. Consequently, whether the plan is part of such an arrangement will affect the determination of whether the plan satisfies the nondiscrimination requirements.

Employers are required to indicate whether a plan is part of such a floor-offset arrangement when they submit a determination letter request and, if so, to provide the name and file folder number (if available) of the other plan and to indicate whether the other plan has received a determination letter or is being submitted simultaneously. This information should be labeled Demo 8. If the plan is represented or appears to be part of such an arrangement and the employer has failed to provide this information, it should be requested.

A floor-offset arrangement will satisfy the safe harbor testing method if:

1. under the arrangement, the accrued benefit under the defined benefit plan is reduced solely by the actuarial equivalent of all or part of the employee's employer-derived account balance (including prior distributions) under a defined contribution plan of the same employer, determined using an interest rate no greater than 8.5 percent;

2. nonforfeitable benefits are offset only by other nonforfeitable benefits;

3. the defined benefit is noncontributory, unless employee contribution feature has been discontinued;

4. the same employees benefit under both plans and the

offset is applied to all employees on the same terms;

5. the same options with respect to investments and preretirement distributions must be available to all employees under the defined contribution plan;

6. the defined benefit plan must satisfy the uniformity and unit credit safe harbor requirements described in Part XI on a gross benefits basis and the defined contribution plan must satisfy any safe harbor or the general test, or the defined contribution plan must satisfy the uniform allocation formula in Part X of Worksheet 5 and the defined benefit plan must satisfy any safe harbor or the general test on a gross benefit basis; and

7. the defined contribution plan must not be a section 401(k) or section 401(m) plan.

An exception in the regulations allows certain arrangements described in section 1165(f)(5) of TRA of 1986 to satisfy these requirements even though a section 401(k) or section 401(m) plan is part of the arrangement.

If the employer has indicated that the plan is part of such an arrangement, the specialist should determine that these requirements are satisfied as this determination will affect the subsequent review of the plan. If necessary, the employer may be asked to furnish the other plan.

1.401(a)(4)-8(d)

X. NONDISCRIMINATORY CONTRIBUTIONS OR BENEFITS

This part of the worksheet deals with the requirement of the regulations under section 401(a)(4) that a plan be nondiscriminatory with respect to the amount of contributions or benefits under the plan.

A plan can satisfy the requirement that it be nondiscriminatory with respect to the amounts of contributions or benefits under the plan in two ways. First, this requirement will be satisfied if the plan satisfies a general test that compares the actual accrual or allocation rates of highly compensated and nonhighly compensated employees under the plan. Second, the requirement will be satisfied if the plan satisfies a nondiscrimination safe harbor. Generally, the safe harbors operate to allow plans to meet the nondiscrimination in amount requirement without actually comparing accrual or allocation rates. These types of safe harbors are referred to as "design-

based." However, there are two safe harbors that merely simplify the process of comparing accrual or allocation rates, without eliminating the need to do so. These are referred to as "nondesign-based" safe harbors.

1.401(a)(4)-1(b)
1.401(a)(4)-2(a)
1.401(a)(4)-3(a)

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line a. When an employer submits a determination letter application, the employer is required to indicate whether the plan is intended to satisfy the requirement that it be nondiscriminatory in amount by meeting one of the design-based safe harbors under the section 401(a)(4) regulations. A design-based safe harbor allows for a determination that the plan, by design, satisfies the nondiscrimination in amount requirement without the need to test the actual allocations or benefits under the plan. If the plan is not intended to satisfy a design-based safe harbor, the employer is given the option of receiving a caveated letter or demonstrating that a general test or a nondesign-based safe harbor is satisfied. Do not complete this part if the employer has indicated that the plan satisfies a design-based safe harbor. Instead, skip to Part XI.

If the plan is not a design based safe harbor plan, the remaining Parts of the worksheet are generally not applicable. However, the explanations for these parts of the worksheets may contain information that is relevant to the determination of whether a plan satisfies a general test or a nondesign-based safe harbor or the average benefits test. In addition, Part XIII of the worksheet, relating to nondiscriminatory compensation, should be completed in the case of a section 401(m) plan that is required to demonstrate that the definition of compensation used in the plan's ACP test is nondiscriminatory.

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line b. If the employer has requested a determination that the plan satisfies a general test, the employer is required to submit a demonstration that the test is met. This demonstration should be labeled Demo 6. A special rule in the regulations provides that under certain circumstances a defined benefit plan that would otherwise fail to satisfy the general test will be considered to satisfy the test if the facts and circumstances warrant such a determination. Employers that are requesting application of this special rule are required to so indicate in their applications and should include with their demonstration a description of the relevant facts and circumstances supporting application of this rule.

See the appendix in Explanation 5C to determine if the plan

satisfies a general test.

1.401(a)(4)-3(c)(3)

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line c. If the employer is requesting a determination that the plan satisfies the alternative safe harbor for flat benefit plans, the employer is required to submit a demonstration that the safe harbor is satisfied. This demonstration should be labeled Demo 6. The instructions for Schedule Q (Form 5300) contains guidelines that employers should generally follow in preparing this demonstration.

A defined benefit plan will satisfy the alternative safe harbor for flat benefit plans if it meets two requirements.

First, the plan must satisfy the fractional rule flat benefit safe harbor described in line XI.a.(iii) of the worksheet, other than the requirement that at least 25 years of service are required to receive the unreduced flat benefit. Therefore, the specialist must first determine that the requirements described in line XI.a. (relating to general defined benefit safe harbor uniformity requirements); line XI.a.(iii) (relating to the fractional rule flat benefit safe harbor), other than the 25 year requirement; and line XI.b. of the worksheet (relating to fresh-start requirements) are satisfied.

Second, for the plan year, the average of the normal accrual rates for all nonhighly compensated nonexcludable employees must be at least 70 percent of the average of the normal accrual rates for all highly compensated nonexcludable employees. (See Part V for the definition of excludable employee.) All nonexcludable employees are taken into account, regardless of whether they benefit under the plan.

Thus, the normal accrual rates for each employee in the two groups must be separately determined and then an average for all employees in each group is determined. The employer is not required to submit information regarding individual normal accrual rates, merely the average rates for the groups of highly compensated and nonhighly compensated nonexcludable employees.

In providing a demonstration of this safe harbor, employers should include with their demonstrations certain information regarding how normal accrual rates have been determined. The concept of normal accrual rate and the manner in which this rate is determined are relevant to the general tests. Therefore, the specialist should refer to the first part of the appendix in Explanation 5C (pertaining to the general test) in evaluating this information. In general, all of the information contained in the appendix pertaining to the general test also has

application to the determination of normal accrual rates for the alternative safe harbor for flat benefit plans, except for information pertaining to the following:

a. the determination of most valuable accrual rate;

b. the grouping of accrual rates;

c. the identification and section 410(b) testing of rate groups;

d. testing on the basis of contributions; and

e. the application of the special rule in section 1.401(a)(4)-3(c)(3) of the regulations.

Paragraphs "a," "b," "f," "r," and "s" of Part 1 of the appendix in Explanation 5C therefore do not pertain to whether a plan satisfies the alternative safe harbor for flat benefit plans.

1.401(a)(4)-3(b)(4)(i)(C)(3)

XI. DESIGN-BASED SAFE HARBORS

This part of the worksheet deals with the design-based safe harbors and should be completed if the employer has indicated that the plan is intended to satisfy such a safe harbor. A design-based safe harbor allows for a determination that the plan, by design, satisfies the nondiscrimination in amount requirement without the need to test the actual allocations or benefits under the plan. The employer is asked to specify the particular safe harbor that the plan is intended to satisfy. Those lines of the worksheet that do no pertain to the specified safe harbor should not be completed.

The remaining parts of the worksheet (XII through XIII) generally should be completed only in the case of design-based safe harbor plans. However, some of the requirements addressed in these parts of the worksheet may be relevant to a determination of whether a plan satisfies a general test or a nondesign-based safe harbor or the average benefit test. In addition, Part XIII of the worksheet, relating to nondiscriminatory compensation, should be completed in the case of a section 401(m) plan that is required to demonstrate that the definition of compensation used in the plan's ACP test is nondiscriminatory.

Line a. In order to satisfy any of the defined benefit safe

harbors, a defined benefit plan must generally satisfy the following uniformity requirements:

1. All employees in the plan are subject to the same benefit formula providing the same annual benefit payable in the same form commencing at the same uniform normal retirement age. Under the formula, the annual benefit is the same percentage of average annual compensation or the same dollar amount for all employees with the same years of service at NRA. (In the case of an employee continuing in service past NRA, the employee's benefit at any later age must equal the benefit (as a percentage of average annual compensation or as a dollar amount) payable to an employee commencing to receive benefits at NRA with the same number of years of service.) Because social security retirement age (SSRA) is a uniform retirement age under section 401(a)(5)(F), differences in employees= benefits that are attributable solely to differences in such employees= SSRAs will not cause a plan to fail to be a safe harbor plan.

If the benefit formula is based on average annual compensation, the compensation formula must be uniform for all employees and nondiscriminatory under section 414(s) (see Part XIII), and the formula must base benefits on a period of at least three consecutive 12-month periods, or the participant's entire period of service if shorter, during which the employee's average section 414(s) compensation was the highest. (If the plan does not provide for permitted disparity and does not base average compensation, for purposes of calculating benefits on <u>consecutive</u> 12-month periods, the "consecutive" requirement for average annual compensation does not apply.)

In making the determination of average annual compensation, the plan must look to the employee's compensation history for a continuous period that ends in the current plan year and is no shorter than the averaging period. The plan can disregard 12-month periods in which the employee terminates employment, performs no service, or performs service for a number of hours that is less than a number of hours specified by the employer (not to exceed 3/4 of full time hours for the 12-month period.) Similar rules allow months to be disregarded when average annual compensation uses 12-month periods that do not end on a fixed date, such as the 60 consecutive months producing the highest average.

If the plan is an accumulation plan, it may use plan year compensation instead of average annual compensation. An accumulation plan (also referred to as a career average plan) separately calculates the compensation and benefit each year and then totals the benefit. Plan year compensation is section 414(s) compensation for the plan year or a 12-month period ending within the plan year. For the year in which participation in the

plan begins or ends, the plan may limit plan year compensation to the period of participation provided the plan year is also the period for determining accruals and the use of period of participation is done in a nondiscriminatory and reasonably consistent manner from year to year.

2. All subsidized optional form of benefit under the plan (other than those that have been prospectively eliminated) are available to substantially all employees in the plan, determined using current availability criteria. (A plan that provides an early retirement window benefit may fail this requirement. However, in this case it may be possible to restructure the plan so that each restructured component separately satisfies this and the other safe harbor requirements.)

3. If the plan is a contributory plan, it meets the requirements in Part XII of the worksheet.

4. The years of service over which the benefit accrues are the same as those taken into account under the plan's benefit formula.

1.401(a)(4)-3(b)(2) and (6)
1.401(a)(4)-3(e)

A plan will not fail to satisfy a safe harbor merely because:

1. The plan provides for permitted disparity in a manner that satisfies section 401(l) and Worksheet 5B.

2. Accruals are limited in accordance with section 415 or the plan provides for increases in accrued benefits based solely on adjustments to the dollar limit under section 415(b)(1).

3. Accruals are limited to a maximum dollar amount or a maximum percentage of compensation, or the amount of compensation or service taken into account is limited, provided these limits apply uniformly to either all employees or only to some or all highly compensated employees.

4. Employees receive reduced accruals for less than a full year of service of participation.

5. The plan has one or more entry dates during the plan year.

6. The plan determines benefits for service after a fresh-start date for all employees under a benefit formula or accrual method that differs from the formula or method previously used to determine benefit accruals for employees in a fresh-start group

for service before the fresh-start date, provided the plan satisfies the fresh-start rules in the regulations (see explanation XI.b.). This, for example, allows a non-safe harbor plan to transition into a safe harbor.

7. The plan provides that an employee's benefit is the greater of, or the sum of, two or more formulas each of which satisfies the safe harbor. Formulas that are available solely to some or all nonhighly compensated employees, but not available to any highly compensated employees, fall within this exception, as do the following types of top-heavy formulas: formulas available solely to all non-key employees on the same terms as other formulas and formulas conditioned on the plan being top-heavy.

8. The plan provides benefits to highly compensated employees that are inherently less valuable than the benefits provided to nonhighly compensated employees.

9. The plan provides a subsidized optional form of benefit that is available to fewer than substantially all employees because the optional form of benefit has been eliminated prospectively.

1.401(a)(4)-3(b)(6)

Certain other special rules may have application to particular plans intended to satisfy a safe harbor. Among these are the following:

1. If the plan provides an early retirement window benefit that consists of a temporary change in the plan's benefit formula (i.e., with respect to those electing to retire during the window), the plan must satisfy the safe harbor requirements both taking the temporary change into account and disregarding it. If such a provision is encountered, the specialist should refer to the example in section 1.401(a)(4)-3(f)(4)(iv) of the regulations that shows how a plan may be restructured to satisfy this requirement.

2. If the plan provides for increases in an employee's accrued benefit solely because of a delay past NRA in commencement of benefits, the increase may be disregarded if the increase factor (percentage) is no greater than the percentage that would be obtained using a standard mortality table and an interest rate between 7.5 percent and 8.5 percent, compounded annually. Thus, where a plan that satisfies all the other safe harbor requirements provides such an increase and offsets the post-NRA accrual by the increase, both the increase and the

offset may be disregarded so that the plan will continue to satisfy the safe harbor.

3. If the benefits under the defined benefit plan are offset by benefits under another plan, two rules that may allow the offset to be disregarded so that the plan may still satisfy a safe harbor. First, if the requirements of the floor-offset safe harbor described in Part IX of the worksheet are satisfied, the offset to the accrued benefit that would otherwise be provided under the defined benefit plan is disregarded in determining whether the plan satisfies a safe harbor. Under this safe harbor, the permitted offset is the actuarial equivalent of all or part of the account balance attributable to employer contributions under a defined contribution plan maintained by the same employer. If the employer indicates that the plan is part of a floor-offset arrangement, Part IX of the worksheet should also be completed.

If the plan includes an offset provision and the requirements of the floor-offset safe harbor are not satisfied, a second rule may operate to allow the disregard of the offset. This rule provides that the employee's accrued benefit includes that portion of the benefit that is offset, provided the benefit by which the plan benefit is being offset is attributable to periods for which the plan credits pre-participation or past service and the offset provision applies on the same basis for all similarly situated employees. See Part VII of the worksheet. In addition, the offset must be for benefits under a qualified DB or DC plan (whether or not terminated), or for benefits under a foreign plan that are reasonably expected to be paid. Finally, nonforfeitable benefits may be offset only by other nonforfeitable benefits.

4. If the plan is a multiemployer plan that includes a requirement to complete up to five years of future service in order to be entitled to an increase in benefits for prior service, this requirement may be disregarded if the requirement applies to all employees in the plan.

1.401(a)(4)-3(f)
1.401(a)(4)-8(d)

(i) A plan will satisfy the unit credit safe harbor if it meets the following requirements:

1. The plan satisfies the 133 1/3 percent accrual rule (see Alert Guidelines 2A).

2. Under the plan, each employee's accrued benefit, as of any plan year, is determined by applying the plan's benefit formula to the employee's years of service and average annual compensation (if applicable) for that plan year.

1.401(a)(4)-3(b)(3)

(ii) A plan will satisfy the fractional rule unit credit safe harbor if it meets the following requirements:

1. The plan satisfies the fractional accrual rule (see Alert Guidelines 2A).

2. Under the plan, each employee's accrued benefit, as of any plan year before NRA, is determined by multiplying the fractional rule benefit by this fraction: years of service as of the plan year over years of service projected to NRA.

3. Under the plan, no employee can accrue, in any one year, a part of the normal retirement benefit that is more than one-third larger than the benefit that any other employee (or potential employee) could accrue, disregarding employees with projected service of more than 33 years at NRA. Solely for the purpose of this requirement, a plan that provides for permitted disparity may treat participants as having received benefits on all compensation at the excess rate or at the rate prior to application of the offset so that the disparity alone does not cause the plan to fail to meet this requirement. If the plan's unit credit benefit formula does not limit the service taken into account to less than 25 years of credited service, and the formula does not provide for a rate increase after a specified number of years of participation, the plan will satisfy this requirement because 33 years does not exceed 133 1/3 percent of 25 years.

1.401(a)(4)-3(b)(4)(i)(C)(1)

(iii) A plan will satisfy the fractional rule flat benefit safe harbor if it meets the following requirements:

1. The plan satisfies the fractional accrual rule (see Alert Guidelines 2A).

2. Under the plan, each employee's accrued benefit, as of any plan year before NRA, is determined by multiplying the fractional rule benefit by this fraction: years of service as of the plan year over years of service projected to NRA.

3. The plan provides a flat benefit at normal retirement age as a percentage of average annual compensation or a flat dollar amount (e.g., 50 percent of average annual compensation) that is the same for all employees in the plan who have a minimum number of years of service at NRA, with a pro rata reduction in the benefit for employees with less than that minimum number of years of service at NRA. (The definition of years of service for this fraction and for the benefit formula must be the same; e.g., the plan cannot use years of service (including pre-plan participation service) for the benefit formula and years of participation for the accrual.)

4. The plan requires at least 25 years of service at NRA for the unreduced flat benefit, determined without regard to the section 415 limitations.

This safe harbor operates to ensure that no employee can accrue the maximum benefit at a rate faster than four percent a year. However, a plan may be designed so that the maximum section 415 benefit accrues over less than 25 years. This is done by having the plan provide for a benefit in excess of the section 415 limits, limiting the accrual of that benefit to four percent a year, and capping the participant's accruals at the section 415 limits.

1.401(a)(4)-3(b)(4)(i)(C)(2)

(iv) A defined benefit plan will satisfy the safe harbor for insurance contract plans if it meets the following requirements:

1. The plan satisfies the accrual rule of section 411(b)(1)(F) (see Alert Guidelines 2A).

2. The plan is an insurance contract plan within the meaning of section 412(i) (see below).

3. The benefit formula under the plan would satisfy the fractional rule unit credit or flat benefit safe harbor if the stated normal retirement benefit accrued ratably over each employee's period of plan participation through normal retirement age. The plan's benefit formula may not recognize years of service prior to plan participation unless the plan was adopted and in effect on September 19, 1991, and then only to the extent then provided in the plan and only to employees who participated on or before that date.

4. Scheduled premium payments under the contract used to fund the employee's retirement benefit are level annual payments to NRA and may not cease before then.

5. Premium payments for an employee who continues to benefit after NRA equal the amount necessary to fund additional benefits that accrue for the plan year.

6. Dividends and forfeitures, etc., are used solely to reduce future premiums.

7. All benefits are funded through contracts of the same series (e.g., with cash values based on the same terms, including interest and mortality assumptions, and with the same conversion rights). A change in the series or insurer that applies on the same terms to all employees will not violate this rule.

8. Disparity must satisfy the permitted disparity regulations (Worksheet 5B for a special adjustment that applies).

A 412(i) plan is one funded exclusively by insurance contracts providing for level annual premium payments from participation (or benefit increase) through NRA. Plan benefits equal contract benefits at NRA and are guaranteed by a state licensed insurance carrier to the extent premiums have been paid. Premiums are payable before lapse or there is reinstatement of the policy. No contract rights are subject to a security interest and there are no outstanding policy loans.
1.401(a)(4)-3(b)(5)

(v) A cash balance plan is a defined benefit plan that defines benefits for each employee by reference to the employee's hypothetical account. The rules for this safe harbor are contained in section 1.401(a)(4)-8(c)(3) of the regulations. These regulations incorporate a design-based safe harbor in section 1.401(a)(4)-8(c)(3)(iii)(B). If the employer has indicated that the plan satisfies this design-based safe harbor, the specialist should refer to the regulations to determine that the requirements of the design-based safe harbor as well as the other requirements of section 1.401(a)(4)-8(c)(3) are met. The specialist should also refer to section 1.401(a)(4)-13(f) of the regulations which contains special fresh-start rules.
1.401(a)(4)-8(c)(3)
1.401(a)(4)-13(f)

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line b. In order to satisfy a safe harbor, a defined benefit plan is generally required to provide a uniform normal retirement benefit. See line b. A plan that has a benefit formula and accrual method for service after a given date that is different from the formula and method for service before that date will not fail the safe harbor requirements provided the plan satisfies the fresh-start requirements. Thus, when a defined benefit plan is

amended to change its benefit formula or accrual method, benefits that are subsequently accrued under the plan must satisfy the fresh-start rules in order for the plan to satisfy a safe-harbor.

The fresh-start rules operate to freeze the accrued benefit generally as of the last day of the plan year preceding the year in which the new formula or accrual method first applies. (This date is referred to as the fresh-start date and the accrued benefit as of that date is referred to as the frozen accrued benefit. A plan may use a date other than the last day of the plan year as the fresh-start date, provided the plan satisfied a safe harbor from the beginning of the plan year through the fresh-start date, or under certain other circumstances that are described below.) The frozen accrued benefit is then either added to the accruals based on the new formula (or method) as applied to service after the fresh-start date or "worn away" (under one of two methods) by accruals under the new formula as applied to all service.

The fresh-start formula generally must apply to all employees with accrued benefits as of the fresh-start date and an hour of service after that date (the "fresh-start group"). However, the fresh-start group may be limited to :

1. section 401(a)(17) employees (see Alert Guidelines #4),

2. members of an acquired group of employees, or

3. employees with frozen accrued benefits attributable to transferred assets and liabilities.

If the fresh-start is limited to the acquired group, the fresh-start date must be the date selected by the employer as the last date of hire or transfer for employees to be included in the acquired group. If the fresh-start is limited to employees with transferred benefits, the fresh-start date must be the date on which these employees begin accruing benefits under the plan.

The frozen accrued benefit can be increased to comply with the average compensation requirement of section 416(c)(1)(D)(i), or, if the requirements described below are satisfied, to reflect employees' future compensation increases.

A plan that is required to include a fresh-start formula must contain one of the following formulas for all employees in the fresh-start group:

1. Each employee's accrued benefit is equal to the sum of:
   a. the employee's frozen accrued benefit, and
   b. the employee's accrued benefit under the new

formula as applied to years of service after the fresh-start date.

This is referred to as the formula "without wear away."

2. Each employee's accrued benefit is equal to the greater of:

a. the employee's frozen accrued benefit, or

b. the employee's accrued benefit under the new formula as applied to the employee's total years of service.

This is referred to as the "wear away" formula.

3. Each employee's accrued benefit is equal to the greater of:

a. the sum determined under formula 1., above, or

b. the amount described in line b. of formula 2., above.

This is referred to as the "extended wear away" formula.

A plan may adjust a participant's frozen accrued benefit in the preceding formulas to take into account compensation increases after the fresh-start date provided the following conditions are satisfied:

1. The plan's benefit formula as of the fresh-start date must have provided for the pre-fresh-start accrued benefits of the employees in the fresh-start group to be adjusted for later compensation (e.g., final average pay plans).

2. The plan's terms must provide that the accrued benefits of each employee in the fresh-start group after the fresh-start date be at least equal to the employee's adjusted accrued benefit (see below).

3. The group of employees with accrued benefits under the plan on the fresh-start date must have satisfied the minimum coverage requirements as of that date.

4. The fresh-start group must satisfy one of the following requirements:

a. it must satisfy the minimum coverage requirements for all years from the first year beginning after the fresh-start date through the current year;

b. it must have satisfied the minimum coverage requirements for the first five years beginning after the fresh-

start date;

c. it must have satisfied the ratio percentage test as of the fresh-start date;

d. it must have consisted of an acquired group that satisfied minimum coverage as of the fresh-start date; or

e. the fresh-start date must have been on or before the effective date of these rules (generally the first day of the 1994 plan year).

5. The plan must provide benefit accruals (other than compensation increases to pre-fresh-start accrued benefits) to the fresh-start group at a rate that is meaningful in comparison to the rate of accrual for the fresh-start group in pre-fresh start years.

6. If the plan provides for permitted disparity, it must make the minimum benefit adjustment that is described below. This minimum benefit adjustment ensures that the benefit in the fresh-start formula satisfies the 2 to 1 rule of section 401(l). The adjustment is not needed if the frozen accrued benefit already satisfies section 401(l).

(In most situations, the specialist will not be able to determine that some of the requirements described above, particularly those relating to meaningful coverage, have been satisfied. This is because these requirements pertain to the plan's ongoing operation. Consequently, these requirements need not be considered when making a determination of whether a plan satisfies the fresh-start rules.)

If the plan meets the foregoing requirements, it may substitute for the frozen accrued benefit in the fresh-start formulas the "adjusted accrued benefit." The adjusted accrued benefit is determined as follows:

First, if the plan provides for permitted disparity as of the fresh-start date, make the following adjustment, if necessary:

a. in an excess plan, adjust the employee's frozen accrued benefit so that the base benefit percentage is not less than 50 percent of the excess benefit percentage; or

b. in a PIA offset plan, adjust each employee's offset so that it does not exceed 50 percent of the benefit determined before the offset.

Second, multiply the frozen accrued benefit (as adjusted in

the first step, if applicable) by the following fraction (not less than one):

$$\frac{\text{the employee's compensation for the current plan year}}{\text{the employee's compensation as of the fresh-start date (determined under the same definition)}}$$

Compensation must either be the definition used in determining the frozen accrued benefit or average annual compensation.

Where the fresh-start occurs before the effective date of these rules (generally the first day of the 1994 plan year), the plan may use a different method to adjust the frozen compensation. Under this method, the employee's frozen accrued benefit is multiplied by the following fraction (not less than one):

$$\frac{\text{the employee's average annual compensation for the current year}}{\text{the employee's reconstructed average annual compensation as of the fresh-start date}}$$

An employee's "reconstructed compensation" is equal to the average annual compensation determined for a pre-1995, post-fresh-start date plan year calculated in accordance with the same method which is in effect for the current year, multiplied by a fraction, the numerator of which is the employee's compensation as of the fresh-start date determined under the same compensation definition and formula used to determine the employee's frozen accrued benefit, and the denominator of which is the employee's compensation for the selected post-fresh-start date plan year, determined under the same definition of compensation and formula used to determine the employee's frozen accrued benefit.

Compensation in the above fractions is subject to the annual compensation limit under section 401(a)(17). However, see Alert Guidelines #4 for special rules concerning "section 401(a)(17) employees".

As an alternative to applying the foregoing fractions to determine an employee's adjusted accrued benefit, the plan may use the following "plug-in" method. Under this method, the plan determines the adjusted accrued benefit by substituting in the benefit formula used to determine the frozen accrued benefit the employee's compensation for the current plan year, determined under the same compensation formula and definition used to determine the frozen accrued benefit. This method may be used only if it is reasonable to expect as of the fresh-start date that, over time, the use of this method rather than the fraction method will not discriminate significantly in favor of HCEs.

1.401(a)(4)-13(c) and (d)

XII. EMPLOYEE CONTRIBUTIONS NOT ALLOCATED TO SEPARATE ACCOUNTS

line a. A defined benefit plan that provides for employee contributions not allocated to separate accounts (i.e., a contributory defined benefit plan) will not satisfy a safe harbor unless it would do so if the plan's benefit formula provided benefits at employee's employer-provided benefit rates, as determined under the nondiscrimination regulations. In other words, if the employer-provided benefit would satisfy a safe harbor, the plan will satisfy the safe harbor irrespective of the contributory feature.

Generally, the employer-provided benefit in a contributory plan is to be determined under the rules in section 411(c). See Alert Guidelines #2A. However, the regulations provide several alternative methods:

1. the composition-of-workforce method

2. the minimum benefit method

3. the grandfather rule

4. the government plan method

5. the cessation of contributions method

The employer should indicate in its application the method it is using. If the plan is a fractional accrual rule safe harbor plan or an insurance contract plan, only the last three methods may be used.

The requirements of each of these methods are as follows:

1. In order to satisfy the composition-of-workforce method, the employer must demonstrate that certain demographic and other requirements are satisfied. See line b.

2. The minimum benefit requirement is satisfied if all employees make contributions at the same rate of plan year compensation and, for plan years beginning after December 31, 1993, each employee accrues a benefit that equals or exceeds the sum of:

a. The accrued benefit derived from employee contributions made for plan years beginning after December 31, 1993, determined in accordance with section 411(c), and

b. Fifty percent of the participant's total benefit (derived from both employer and employee contributions) accrued in plan years beginning after December 31, 1993 (determined without regard to that portion of the benefit formula designed to satisfy the minimum benefit requirement.)

Note that this is just a minimum benefit. The participant is entitled to his or her vested accrued benefit determined under the plan's benefit formula if greater.

3. The grandfather rule, which applies to certain plans with graded employee contribution that were in existence on May 14, 1990 (as well as certain multiple employer plans), is satisfied if the employer demonstrates that the requirements described in line c. are satisfied.

4. The government plan method applies to any government plan.

5. The cessation of employee contributions method is satisfied if no employee contributions may be made to the plan after the last day of the 1994 plan year.

The determination of the employer-provided benefit under each of these methods is as follows:

1. Composition-of-workforce. If the plan is not a section 401(l) plan, treat the entire accrued benefit as employer-provided. If the plan is a section 401(l) plan, see Worksheet 5B.

2. Minimum benefit method. If the plan is not a section 401(l) plan, treat the entire accrued benefit as employer-provided. If the plan is a section 401(l) plan, see Worksheet 5B.

3. Grandfather method. Subtract from the total benefit the employee-provided benefit determined under a reasonable method in the plan that conforms to the demonstration described in line c.

4. Government plan method. Treat the entire accrued benefit as employer-provided.

5. Cessation of contributions method. Treat the entire accrued benefit as employer-provided.

1.401(a)(4)-3(b)(6)(viii)
1.401(a)(4)-6(b)

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line b. The employer may use the composition-of-workforce method to determine the employer-provided benefit if employee's make

contributions at the same rate (percentage of plan year compensation) and the employer submits a demonstration that the plan satisfies certain demographics requirements. This should be labeled Demo 10. If the employer provides such a demonstration, the specialist should refer to section 1.401(a)(4)-6(b)(2)(ii)(B)(2) and (3) to determine that either the minimum percentage test or the ratio test described therein is satisfied.

1.401(a)(4)-6(b)(2)

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line c. The plan must separately satisfy section 401(a)(4) with respect to the amount of employee-provided benefits.

Generally, the plan will satisfy this requirement if the contributions are made at the same rate, as a percentage of compensation, by all employees under the plan.

This requirement is also satisfied if the total of employer-provided and employee-provided benefits satisfies the nondiscrimination in amount requirement.

Finally, if the employer is using the grandfather rule, this requirement will be satisfied if the employer demonstrates that the benefits provided on account of employee contributions at lower levels of compensation are comparable to those provided at higher levels of compensation. This should be labeled Demo 11.

1.401(a)(4)-6(c)

XIII. NONDISCRIMINATORY COMPENSATION

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line a. If a design-based safe harbor plan bases benefits or contributions on compensation, it must use a definition of compensation that is nondiscriminatory under section 1.414(s)-1 of the regulations. (The requirement to use a nondiscriminatory definition of compensation would also apply in the case of the definition of compensation that a section 401(k) or 401(m) plan must use in its actual deferral percentage (ADP) or actual contribution percentage (ACP) test.) The regulations contain certain definitions that are automatically nondiscriminatory under section 414(s). A plan may use an alternative definition, provided the definition is reasonable, not designed to favor highly compensated employees, and if the facts and circumstances show that the average percentage of total compensation included for highly compensated employees as a group does not exceed the average percentage for nonhighly compensated employees by more than a de minimis amount. In addition, under certain circumstances a plan may use rate of compensation, imputed compensation, or prior-employer compensation under a definition

of compensation that satisfies section 414(s).

The following definitions of compensation automatically satisfy section 414(s):

1. Compensation within the meaning of section 415(c)(3). For years beginning after December 31, 1997, this definition of compensation includes elective deferrals defined in section 402(g)(3) and amounts deferred under a section 125 cafeteria plan or under a section 457 plan. Under this definition, a self-employed person's compensation is earned income as defined in section 401(c)(2).

2. Wages as defined in section 3401(a) plus all other compensation required to be reported by the employer under sections 6041, 6051 and 6052, or wages as defined in 3401(a), both determined without regard to any rules that limit wages based on the nature or location of employment.
3. A safe-harbor definition that starts with 1 or 2, but excludes all of the following: reimbursements or other expense allowances, fringe benefits, moving expenses, deferred compensation, and welfare benefits. This safe-harbor generally permits the following definition to fall within the scope of section 414(s): Regular or base salary or wages, plus commissions, tips, overtime and other premium pay, bonuses, and any other item of compensation includible in gross income not listed in the safe-harbor exclusions. If this definition is used, any self-employed individual's compensation is to be limited to earned income multiplied by the percentage of nonhighly compensated employees' total compensation (determined on a group basis) that is included under the plan definition.

Under any of these definitions, the employer can elect to include or exclude elective contributions not includible in income, section 457(b) deferred compensation, and section 414(h)(2) pick-up contributions. If any of these are included (excluded), they must all be included (excluded).

1.414(s)-1

If the plan's definition of compensation does not meet any of the preceding definitions, then the applicant is required to submit a demonstration that, under the plan definition, the average percentage of total compensation included for highly compensated employees as a group does not exceed the average percentage for nonhighly compensated employees by more than a de minimis amount. (Self-employed individuals are not counted in either group.) This demonstration should be labeled Demo 9.

The plan definition must also be reasonable and not designed to favor highly compensated employees. A definition is

reasonable only if it is described in one of the four preceding paragraphs and modified to exclude certain types of irregular or additional compensation or is limited to a dollar amount. (However, see below for rules allowing definitions of compensation that are based on rate of compensation or that include prior-employer compensation or imputed compensation.)

For this purpose, total compensation means compensation based on one of the definitions permissible under section 415(c)(3) (either including or excluding all elective contributions, etc.), limited to the amount described in section 401(a)(17). If the plan's alternative definition excludes amounts from the compensation of some (but not all) highly compensated employees, these amounts must also be excluded from the same employees' total compensation.

The employer may elect to consider either all employees in the plan (other than self-employed individuals) or all employees (other than self-employed individuals) in all the plans that use the same alternative definition of compensation in performing this calculation. Employees who have no total compensation are disregarded for purposes of testing a definition of compensation.

Whether the average percentage of total compensation included for highly compensated employees as a group exceeds the average percentage for nonhighly compensated employees by more than a de minimis amount is a question of facts and circumstances. The applicant should submit an explanation supporting a claim that such a difference is de minimis. This may include showing the difference for prior periods. Also, a difference that is more than de minimis may be disregarded if it is an isolated instance due to an extraordinary, unforeseeable event (such as overtime payments due to a major hurricane).

1.414(s)-1(d)

A plan can base allocations or benefits on employees' basic or regular rate of compensation using an hourly pay scale, weekly salary, or similar unit of basic or regular compensation. (Rate of compensation may not be used in a definition used for ADP or ACP testing in a section 401(k) or section 401(m) plan.) A plan could also, for example, define compensation as basic or regular compensation, determined using a rate of compensation, plus irregular or additional compensation. The amount of basic or regular compensation must be determined using the rate of compensation as of a designated date or dates. Also, if the plan does not use the same date to determine employees' rates of compensation, the dates selected must be designed to determine such rates in a consistent manner. An employer may continue to credit an employee who has ceased performing services with compensation based on a rate of compensation for up to 31 days

after the event causing the cessation.

A defined benefit plan can include imputed compensation or prior-employer compensation in an alternative definition of compensation. Prior-employer compensation is compensation from another employer credited for periods prior to the employee's employment with the employer. Imputed compensation is compensation credited for periods after commencement of participation in the plan while the employee receives no compensation or reduced compensation because no services or reduced services are performed for the employer. Included in this definition of imputed compensation would be compensation credited while the employee is performing services for a joint venture.

If the employer is including prior-employer or imputed compensation in the plan's definition of compensation, the provisions must apply to all similarly situated employees, there must be a legitimate business purpose for crediting the service, and the provisions must not by design or operation significantly favor highly compensated employees. A definition of compensation that credits prior-employer compensation or imputed compensation must actually be used to calculate benefits under the plan.

If the definition of compensation includes rate of pay, the definition must be demonstrated to be nondiscriminatory. If the definition includes prior-employer or imputed compensation, it must also be shown to be nondiscriminatory unless the definition is otherwise one of the safe harbor definitions.

If the employer is providing a demonstration with respect to a definition that includes rate of compensation, imputed compensation, or prior-employer compensation, the following adjustments apply to the testing method:

1. Compensation treated as include under the alternative definition (the numerator in the test), may not exceed 100 percent of total compensation.

2. Total compensation (the denominator in the test) must include all elective contributions and deferred compensation that could otherwise be disregarded and may not include prior-employer or imputed compensation.

1.414(s)-1(e) and (f)

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line b. If the plan is using a definition of compensation permissible under section 415(c)(3), then it must define compensation for any self employed individual as earned income within the meaning of section 401(c)(2).

If the plan is using the alternative safe harbor definition that excludes certain expenses and other items or an alternative definition that requires a demonstration, then the terms of the plan must provide for an equivalent alternative definition for self-employed individuals, determined as follows.

The self-employed individual's earned income (increased by elective contributions, if any of these are included in the plan's alternative definition) is multiplied by the percentage of total compensation (including elective contributions, if any of these are included in the plan's alternative definition) that is included for the group of nonhighly compensated common-law employees. (This calculation is to be performed consistent with the rules for determining whether an alternative definition of compensation is nondiscriminatory, except that highly compensated common-law employees are disregarded.)

The plan's alternative definition may also limit the compensation of some or all self-employed individuals who are also highly compensated employees to a portion of the equivalent compensation.

1.414(s)-1(g)